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Advancing to Corporate Tax Integration: A Laissez-Faire Approach

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ADVANCING TO CORPORATE TAX INTEGRATION: A LAISSEZ-FAIRE APPROACH

ANTHONY P. POLITO*

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I. INTRODUCTION

The classical double taxation system applicable to corporations has been flawed for decades. It has introduced serious allocative distortions into the economy. Its effect on the distributive justice of the tax burden is most charitably described as uncertain, but might also be described as arbitrary and capricious. Significant remediation of this regime arrived recently in the form of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act),¹ but from the perspective of the tax integration agenda, it too is flawed. While qualified dividend income is to be taxed at capital gains rates rather than ordinary income rates,² and that change has the effect of mitigating the excess

1. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

2. *Id.* § 302, 117 Stat. at 760-64.

burden of double taxation, it does not eliminate it. Moreover, even that mitigation is scheduled to expire at the end of 2008.³

The double tax regime and its remediation are both flawed, but so is every other tax regime. The decision to tax income, or any other measure defined by economics, is itself an exercise in resolving a "second best" problem.⁴ One might like to distribute tax burdens in relation to ability to pay, the benefits received from the state, or a principle of just redistribution of society's wealth, but none of these is susceptible of direct measurement or definition and one must revert to a definable measure that correlates strongly with the chosen norm of tax justice.⁵ Hence the taxation of income; but the taxation of income is not an end in itself. To the extent that the pure definition of economic income diverges from ability to pay⁶ or some alternative norm of tax justice, the selection of income as the tax base produces maldistribution of the tax burden.

On the other hand, an economically pure definition of income would subject all income to like tax treatment without regard to the manner of its generation. It would entail, therefore, no discrepancies in the treatment of various economic activities, thereby avoiding the allocative inefficiencies resulting from the imposition of tax burdens that discriminate among economic activities.⁷ The actual measure of taxable income, however, must diverge in

3. *Id.* § 303, 117 Stat. at 764.

4. Briefly stated, the theory of the second-best instructs that, if at least one market is prevented from reaching its efficient equilibrium, it is not clear that the welfare maximizing program will be to achieve efficient equilibria in the remaining markets. It is possible that creating distortions in some markets will allow a more than offsetting reduction in distortions in other markets. Therefore, if some allocative biases are unavoidable, economic welfare is generally not maximized by eliminating all other distortions relative to optimal conditions. *See generally* R. G. Lipsey & R. Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956) (explaining the theory of the second-best); *see also* Edward Foster Hugo Sonnenschein, *Price Distortion and Economic Welfare*, 38 ECONOMETRICA 281 (1970); Kunio Kawamata, *Price Distortion and Potential Welfare*, 42 ECONOMETRICA 435 (1974) (stating elegantly the second best proposition). For a general discussion of the theory of the second best, *see* P.R.G. LAYARD & A.A. WALTERS, MICROECONOMIC THEORY 180-88 (1978).

5. *See* Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761, 762-66 (1998); Anthony P. Polito, *The Role of Prescription in the Interpretive Problem of Basis Determination*, 53 TAX LAW. 615, 621-25 (2000).

6. Ability to pay is probably the most commonly asserted norm of tax justice, especially within the realm of politicians. *See, e.g.,* Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 243, 243 (1946).

7. Because a pure-form income tax cannot impose an equivalent tax on the value of leisure time, even it distorts the decision between work and leisure; the price of leisure—the after-tax wage—is affected by the unbalanced tax treatment. In theory, the effect of changing taxes on wages is ambiguous. An incremental tax cut increases the individual's marginal cost of leisure, thereby inducing an increase in labor at the expense of leisure, but it simultaneously makes the individual richer, thereby inducing an increased consumption of leisure at the expense of labor. These are termed the "substitution effect" and the "income effect," respectively. It is commonly

some measure from the pure definition of economic income.⁸ As such, it does entail discrepancies in tax treatment and does bias at least some economic decisions.

In an idealized income tax regime, individual participants of various business enterprises would bear tax liability without regard to the form of those business enterprises. The existing double tax regime for corporate enterprises departs seriously from that ideal, generating allocative and distributive distortions. As a practical matter, however, the idealized alternative to the double tax system, an integrated income tax, is no more attainable than is the idealized income tax as a whole. Conventional wisdom has always held that anything approaching the integrationist ideal would entail prohibitive administrative burdens, and its comprehensive adoption by a sweeping piece of legislation is politically unlikely even under the best of circumstances. Even the George W. Bush Administration, which originally proposed a very far reaching tax integration scheme,⁹ settled for no more than partial temporary dividend relief.¹⁰ The Bush Administration has assembled legislative majorities for two tax cut acts,¹¹ each of which reduces revenues by hundreds of billions

thought that the substitution effect dominates over some range of after-tax wages but that the income effect comes to dominate at higher after-tax wages. As such, in practice the net effect of the tax-induced price of leisure distortion is uncertain. See HAL R. VARIAN, MICROECONOMIC ANALYSIS 145-46, 341-42 (3d ed. 1992).

8. In principle, a comprehensive mark-to-market income tax regime would tax the full measure of each taxpayer's economic income in any period. For a thorough discussion of mark-to-market taxation, see David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986). In practice, however, the assertion that mark-to-market accounting leads to the taxation of all economic income is something of an exaggeration. No proposed tax regime would include in taxable income the full value of consumption occurring outside of market transactions, such as the imputed rental value of consuming one's own property, the imputed value of one's own services performed for one's self, and the value of consuming leisure time. In theory, a mark-to-market regime could capture imputed rental income by marking consumption assets to market and treating the decrease in value as amounts of consumption to be included in income. In the alternative, it might treat the full cost of consumption assets as taxable in the year of acquisition, but this might be unpalatable in the case of durable goods consumed over long periods of time, such as homes and cars. Even this regime would not tax the value of self-performed services and leisure time. In the context of transactionalist income taxation, the most aggressive proposals have called only for the inclusion of the rental value of owner-occupied housing in taxable income. See Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 947-48 (1967). As such, the existence of some distortions of economic decision making is unavoidable.

9. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 11-22 (2003).

10. See *supra* notes 1-3 and accompanying text.

11. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

of dollars over its life, but the proposal for a nearly comprehensive integration proposal was eclipsed by other tax cutting priorities.

At the same time that the double tax regime seems unlikely to yield to a single comprehensive solution, it is leaky, and increasingly so. Taxpayers avail themselves of a plethora of opportunities to avoid double taxation. Policy-makers have created some of those opportunities quite intentionally, while others arise out of the exploitation of the unavoidable interstices that exist in the tax law as much as in any other area of law. The existence of these leaks has, at least in the past, led the Treasury and Congress to attempt to minimize the taxpayer-driven evisceration of the double tax regime. That effort has produced legal complexity and administrative burdens for both tax collectors and taxpayers.

The advancement of corporate tax integration via this Article's Laissez-Faire Approach is premised on the coexistence of these two truths. Unlike other integration proposals, this approach is not a prescription for a comprehensive integration scheme to be implemented with significant administrative burden and through the adoption of significant new legal regimes to further complicate the existing tax law. The Laissez-Faire Approach proposes an alternative that accepts the flawed nature of all tax systems and attempts to put taxpayers' native desire to escape double taxation to good use.

There are numerous points in the existing tax regime in which taxpayers' successful attempts to avoid taxation would have the effect of mitigating or nearly eliminating the excess tax burden of the double tax regime. In as much as taxpayers seek to avoid double taxation, the Laissez-Faire Approach counsels acquiescence and even affirmative steps to facilitate that self-help mitigation of the excess burden of double taxation. The Laissez-Faire Approach further seeks to advance the integrationist ideal without incurring the burden of actively pursuing that unattainable ideal. At the same time, it spares the tax system of the administrative cost generated by defending the integrity of a double tax regime that ought, in any case, to be eliminated. The resulting regime will be flawed, as compared either to a pure double taxation system or to an idealized integrated system. Nevertheless, it has the virtue of advancing the integrationist agenda in a manner that is practicable and sustainable.

This Article sets out the Laissez-Faire Approach in the following manner. Part II lays out the case for an integrationist norm. It advances the thesis that the case against the double tax regime is sufficiently strong that integrationism should be regarded as normative even in the absence of a comprehensive integration program. Part III lays out the conditions for judging a proposal to be consistent with the Laissez-Faire Approach. First, elements in the Laissez-Faire Approach are designed to avoid, to the extent possible, the need to fashion new legal or enforcement regimes. Instead, the elements of the Laissez-Faire Approach are principally designed to eliminate or disregard existing legal

and enforcement regimes. The regimes marked for removal or disregard are those that serve to defend the double-tax anti-ideal. Second, the Laissez-Faire Approach is not a program to facilitate avoidance of income taxation entirely. It avoids mechanisms that would allow income to escape the equivalent of the full burden of the individual tax. In essence, the Laissez-Faire Approach facilitates corporate escape from double taxation, so long as doing so preserves at least one level of taxation. Parts IV through XI outline a series of initiatives that would have the effect of advancing the integrationist agenda consistent with those conditions. It is important to bear in mind that these initiatives are not so much a comprehensive program as an orientation for policy actions. Many of them are no doubt susceptible of further refinement, and other elements that would promote the integrationist agenda could no doubt be added. The Laissez-Faire Approach is just that—an approach. Any policy or practice consistent with its conditions is a candidate for inclusion.

II. THE CASE FOR AN INTEGRATIONIST NORM

Examinations of the adverse effects of the double tax regime can be found in a significant body of economic and legal scholarship.¹² It is, nevertheless, useful to examine the issues of that analysis here. To some extent, this discussion is presented to motivate the general desirability of some program of corporate tax integration and, in part, for the convenience of the reader. More important than these considerations, however, is that the Laissez-Faire Approach advances the integrationist agenda solely through adjustments at the margins of the existing tax regime. Its motivation is that the case against the double tax regime is sufficiently strong that integrationism should be seen as normative even in the absence of comprehensive reform of corporate taxation. Therefore, the analysis of the flaws of double taxation serves to legitimate integrationism as the normative baseline against which even the existing corporate tax regime is to be examined.

12. Two important studies of the problem of integration have been conducted under the auspices of the American Law Institute and the Treasury Department, respectively. See ALVIN C. WARREN, JR., *INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES*; REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (The American Law Institute ed., 1993) [hereinafter ALI STUDY]; U.S. DEP'T OF THE TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, TAXING BUSINESS INCOME ONCE* (1992) [hereinafter TREASURY STUDY]. A large number of articles have been written on the problem of corporate tax integration and it is unrealistic to list them all here. Many are noted in the bibliographies of the ALI STUDY and the TREASURY STUDY.

A. Allocative Efficiency

The analysis begins with the four senses in which the double tax system distorts economic decision making.¹³ First, it biases the decision whether to distribute corporate earnings. Second, it creates a bias against equity capitalization. Third, it creates a bias against investment in corporate capital. Fourth, it compounds the income tax's general bias against capital formation.¹⁴

First is the double tax system's distortion in corporate policy with regard to the distribution of earnings.¹⁵ A policy of retaining earnings generally reduces the effective rate of shareholder-level tax in two ways. Corporate earnings are generally not subject to shareholder-level taxation until distributed or reflected in gain on the sale of corporate stock.¹⁶ That deferral effectively

13. The income tax law has mechanisms that allow taxpayers to mitigate the deleterious effects of the double tax system, but they operate largely by allowing taxpayers to escape double taxation. This part focuses on the misallocations that arise out of an undiminished double taxation regime.

14. The behavioral biases of these distortions serve to shift the incidence of the tax. *See infra* notes 91-92 and accompanying text.

15. It is somewhat conventional to treat the bias against corporate capital as the first distortion of the double tax. Because the extent of the bias in capitalization and corporate form depends in part upon how taxation interacts with dividend policy, the dividend distortion is examined first.

16. Shareholders generally do not account for corporate earnings until they receive them as dividend distributions, I.R.C. § 61(a)(7) (West 2003), or as gain upon the sale of shares, *Id.* § 61(a)(3). As such, shareholders' taxable income does not necessarily fully reflect income realized for their benefit within the corporate form. *See also* RICHARD GOODE, *THE CORPORATION INCOME TAX* 198-200 (1951) (discussing the lack of integration of corporate and individual taxes); Robert C. Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 100-04 (1977) (explaining the distribution principle); George K. Yin, *A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax*, 78 GEO. L.J. 1837, 1841 (1990) (comparing dividend distribution with retained corporate earnings). The ability to use corporations to minimize tax burdens through the retention of earnings faces an outer limit, in the form of the accumulated earnings tax, I.R.C. §§ 531-537 (West 2003). *See generally*, BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 7.01-7.09 (6th ed. 1998) (summarizing the accumulated earnings tax). With proper planning, however, corporations are generally able to accumulate substantial earnings as working capital. *See, e.g.*, Fred B. Davenport, Jr., *Effective Use of Working Capital Formula Can Avoid Accumulated Earnings Tax*, 35 TAX'N ACCT. 248 (1985). Other devices designed to minimize the benefits of deferral are the personal holding company provisions, I.R.C. §§ 541-547 (West 2003); BITTKER & EUSTICE, *supra*, at ¶¶ 7.20-7.24, and the collapsible corporation rules, I.R.C. § 341 (West 2003); BITTKER & EUSTICE, *supra*, at ¶¶ 10.60-10.66.

In a similar vein, earnings retained in a foreign corporation not subject to United States corporate income taxation and subject to relatively low tax rates abroad are effectively subject to a lower tax burden than are similar earnings of corporations subject to the United States corporate income tax. *See* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for*

reduces the shareholder-level tax.¹⁷ In addition, to the extent that the earnings have until now been taxed not as dividend but as capital gains on the disposition of the equity, they have been generally subject to a preferred tax rate.¹⁸ At the same time, to the extent that the personal tax rate differs from the corporate tax rate, the after-tax return to investments of distributed earnings may be greater or less than the after-tax return to investments of retained earnings. The bias, therefore, is not necessarily one against distribution, and the direction of the bias depends upon the relationship among the corporate tax rate, the normal shareholder-level tax rate, and the effective capital gains tax rate (taking deferral into account).¹⁹ Nevertheless, useful generalizations are possible.

To the extent that corporate earnings are eventually to be distributed in a manner that will subject them to the ordinary shareholder-level tax and will not be implicitly taxed as capital gains in the interim, the bias is clearly against distribution. The bias can be demonstrated by examining the after-tax value, over any given time horizon of y years, for an amount of corporate earnings either (i) retained for corporate investment at a rate of return r and distributed as a dividend at the end of the period or (ii) distributed as earned to shareholders, subject to ordinary taxation, and invested at the same rate of return. In particular, retention is preferred if:

$$(1 - d)E[1 + r(1 - c)]^y > (1 - d)E[1 + r(1 - p)]^y$$

where E is the amount of corporate earnings, c is the corporate tax rate, d is the tax rate applicable to dividend distributions, and p is the ordinary personal tax rate applicable to individual taxpayers' ordinary nondividend income.²⁰ Under these conditions, the corporate tax creates a bias against distribution so long as

Simplification, 74 TEX. L. REV. 1301, 1324 (1996). A number of provisions serve to reduce the efficacy of this form of deferral. See I.R.C. §§ 551-558 (foreign personal holding company rules); *Id.* §§ 951-964 (controlled foreign corporation rules); *Id.* § 1248 (disposition of stock in certain foreign corporations); *Id.* §§ 1291-298 (passive foreign investment company rules). See also, BITTKER & EUSTICE, *supra*, at ¶¶ 15.40-15.65 (explaining the mentioned I.R.C. sections).

17. See Anthony P. Polito, *Borrowing, Return of Capital Conventions, and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467, 472 n.9 (1998) (calculating the time period in which tax deferral effectively pays for itself through the opportunity to invest the deferred tax without accounting for the time value of money).

18. I.R.C. § 1(h) (West 2003). Gain may escape taxation entirely if taxpayers receive appreciated stock at the death of its previous holder. *Id.* § 1014.

19. See ALI STUDY, *supra* note 12, at 28-33.

20. This comparison appears to be the pertinent one to the extent that the so-called "new view" of dividend policy is correct, see discussion *infra*, because the new view assumes that corporations are not able, as a practical matter, to convert distributions to capital gains by means of stock redemptions.

the corporate tax rate is lower than the shareholder tax rate, because the retention subjects future earnings, with respect to the amount retained, to a lower tax rate than applicable to earnings distributed and invested at the shareholder-level.²¹

The maximum corporate tax rate has been lower than the maximum shareholder tax rate for most of the history of the income tax.²² The terms of the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Tax Act), as well as those of the 2003 Tax Act, mitigate this form of the bias against dividends, because the new maximum individual tax rate matches the maximum corporate tax rate of 35%.²³ This reform, however, does not eliminate the bias against dividends with respect to corporations subject to less than maximum tax rates.²⁴

In the alternative, assume that retained earnings are always removed from corporate solution via a transaction subject to capital gains rates.²⁵ The nominal capital gains tax rate is lower than the historically “normal” ordinary shareholder-level tax rate.²⁶ So long as the shareholder-level tax rate is higher than the corporate tax rate, retention is always preferred.²⁷ Even for corporate rates in excess of shareholder rates, retention is preferable if the capital gains

21. ALI STUDY, *supra* note 12, at 30.

22. See JAMES S. EUSTICE ET AL., THE TAX REFORM ACT OF 1986 ¶ 2.02[1][c] (1987); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13201(a), § 13221(a), 107 Stat. 312, 457-59, 477; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101(a), 104 Stat. 1388, 1388-403, 04.

23. Under the terms of the 2001 Tax Act, the maximum stated personal tax rate was scheduled to be reduced to 35% by 2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41-42. The 2001 Tax Act has also scheduled the repeal of deduction phase-outs that will be fully effective in 2010. *Id.* §§ 102-103, 115 Stat. at 44-45. Those phase-outs currently increase many taxpayers’ effective tax rates above the stated rates. The 2003 Tax Act accelerated the tax rate reduction. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 105, 117 Stat. 752, 755.

24. See *infra* Part III. Note that reducing the dividend tax rate, d , without reducing the tax rates applicable to nondividend ordinary income, has no effect on this bias. Whether earnings are retained or distributed immediately, d applies once, and the pertinent comparison is whether the taxation of reinvested earnings over the subsequent y years is greater in corporate solution or outside of corporate solution. As such, the 2003 Tax Act does not affect this particular comparison.

25. This can be accomplished in many cases by means of repurchasing corporate shares, see I.R.C. § 302 (West 2003), especially via open-market repurchases. Given the anonymity of modern public markets, it is difficult, if not impossible, to distinguish open-market sales in which the purchaser is the issuer from those in which the purchaser is a third party. As such, applying the statutory tests for the dividend equivalence is not practicable, and these transactions are undoubtedly treated as capital gains transactions.

26. *Id.* § 1.

27. In addition, this effect creates a bias in favor of using nondividend methods to remove earnings from corporate form. See ALI STUDY, *supra* note 12, at 39-40.

rate is sufficiently below the ordinary shareholder-level tax rate.²⁸ The comparison of after-tax values above is slightly modified to indicate that retention is preferred if:

$$(1 - k)E[1 + r(1 - c)]^y > (1 - d)E[1 + r(1 - p)]^y$$

where k is the nominal capital gains tax rate.²⁹ Given $k < d$, this expression holds for all values where $c \leq p$ and for some values of $c > p$. Given historic practice of setting $d = p$ and a historic tendency to set maximum corporate tax rates at no more than the maximum individual income tax rates,³⁰ the corporate tax biases the decision whether to distribute earnings, and likely has created a bias against the distribution of earnings. The 2003 Tax Act temporarily sets $d = k$,³¹ and ensures a bias for all $c < p$, but it temporarily eliminates the bias to the extent that $c = p$.³²

The significance of the bias that the double tax regime imposes on dividend policy depends in large measure upon the relative descriptive powers of economic theories commonly referred to as the “new view” and the “traditional view” of corporate dividend policy. The new view’s necessary predicates are as follows: (1) except for taxes and transaction costs, investors view dividend distributions and capital gains as perfect substitutes, and (2) as a practical matter, corporations have no alternative to cash dividends for distributing earnings to shareholders. Given a higher effective tax burden on distributed earnings than on retained earnings, the new view suggests that a corporation should satisfy its entire need for equity capital out of retained earnings, rather than the issuance of new stock. A corporation will distribute earnings, according to this view, only to the extent that it lacks investment opportunities whose returns would cover the opportunity cost of capital.

If true, then, at the time the double tax is imposed, dividend payout policy is permanently adjusted to minimize the excess tax burden on distributed earnings over retained earnings. For existing companies, the excess tax burden on dividends has been capitalized into the value of shares, reducing their value. The reduction in value, however, is a pure transfer from shareholders to the fisc

28. See *id.* at 32.

29. This appears to be an appropriate comparison to the extent that the so-called “traditional view” of dividend policy, see discussion *infra* notes 33-38 and accompanying text, is thought accurate, and corporations seek to minimize the excess tax burden on distributions by converting them into capital gains.

30. See *supra* note 22 and accompanying text.

31. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64.

32. For a discussion of the circumstances under which the corporate tax would create a bias in favor of distribution, see ALI STUDY, *supra* note 12, at 28-39.

that causes no net reduction in the pre-tax value of the corporate enterprise. The excess tax burden on dividends is a lump-sum tax. Eliminating it generates a windfall to shareholders without any meaningful improvement of allocative efficiency.

In contrast, the traditional view is that a corporation experiences real nontax benefits to the payment of dividends. A variety of possible explanations have been advanced as to why investors prefer stocks that pay regular dividends. A commonly advanced thesis is that given asymmetric information about a corporation's profitability, dividends serve to signal profitability to capital markets. Earnings distributions serve as effective signals because, the less profitable a corporation is, the greater the finance cost it must incur to replace the capital lost through distribution. A sufficiently profitable corporation has no need to replace the amounts of distributions. Hence, the dividend distribution is less costly for profitable enterprises than for unprofitable enterprises.³³

Another view is that dividend distributions serve to limit the agency costs associated with the ownership-control separation of the "Berle-Means corporation."³⁴ As Professor Michael Jensen observed:

Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers' power by increasing the resources under their control. It is also associated with increases in managers' compensation,

33. See B. Douglas Bernheim, *Tax Policy and the Dividend Puzzle*, 22 RAND J. ECON. 455 (1991); Sudipto Bhattacharya, *Imperfect Information, Dividend Policy, and "The Bird in the Hand" Fallacy*, 10 BELL J. ECON. 259 (1979); Kose John & Joseph Williams, *Dividends, Dilution, and Taxes: A Signalling Equilibrium*, 40 J. FIN. 1053 (1985); Merton H. Miller & Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 J. FIN. 1031 (1985). See also Gustavo Grullon, *The Information Content of Share Repurchase Programs* (Jan. 2000) (unpublished manuscript, on file with the *South Carolina Law Review*) (finding that share repurchases may convey information that share prices are undervalued); Oded Sarig, *A Longitudinal Analysis of Corporate Payout Policies* (Oct. 1999) (unpublished manuscript, on file with the *South Carolina Law Review*) (finding that "unexpected increases in corporate payout are associated with long-term subsequent increases in profitability"). Professor Grullon finds that firms in his sample experienced a decline in return on assets during the three years following a share repurchase. He suggests that this evidence indicates firms decide to repurchase shares when they face a reduction in their investment opportunity sets. Such a motivation is consistent with an agency-cost reduction motivation for corporate distributions. See *infra* notes 35-37 and accompanying text.

34. The term "Berle-Means corporation" refers to a corporation whose stock is subject to widely dispersed public shareholding, resulting in ownership-control separation. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 354-56 (1933); see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (discussing the ownership-control separation within corporations).

because changes in compensation are positively related to the growth in sales. The tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates a strong organizational bias toward growth to supply the new positions that such promotion-based reward systems require.

. . . Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.³⁵

The distribution of such free cash flows may serve as an effective signal of corporate management's commitment to reduce agency costs.³⁶

A third possibility is that shareholders may not view the sale of shares as a perfect substitute for dividends, notwithstanding that finance theory indicates that they should be perfect substitutes. There are various possible explanations for such a phenomenon. Individuals may use strict rules as means of limiting their own behavior. Therefore, they may refuse to sell any stock for current consumption because they fear that, once begun, they will not be able to limit themselves. They prefer stock with predictable dividends as a means of disciplining their own selection between current consumption and capital accumulation. Alternatively, over some ranges of outcomes, individuals may fail to integrate the component parts of risky activity, viewing the dividend distribution as "safe" income whose distribution is unconnected to changes in the underlying share's value. Last, individuals may experience a greater degree

35. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) (citations omitted).

36. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Jensen, *supra* note 35, at 324. Professor Gustavo Grullon found that the announcement of open-market share repurchase programs conveys significant information about managers' commitment to reducing agency costs. As evidence of a desire to reduce agency costs associated with free cash flow, he found (1) "a significant decline in profitability, systematic risk, and capital expenditures after share repurchase[s]," and (2) "that the market reaction to share repurchase announcement is negatively related to the firm's marginal return on investment." Grullon, *supra* note 33, at 2. These indicate that share repurchases arise from a reduction in a firm's investment opportunity set, in which case distribution of earnings insures against the agency cost of sub-optimal corporate investment. *Id.*

of “regret” from the foregone possibility of share appreciation attendant with a stock sale than from the same forgone possibility attendant with failure to reinvest cash dividends.³⁷

As a result, *ceteris paribus*, shareholders require a lower after-tax rate of return with respect to stock that pays regular dividends than for stock that does not pay dividends. As such, a corporation should attempt to match distributions to its optimal dividend payout ratio, at which the value of the corporate enterprise is maximized.³⁸ If this view is correct, corporations will pay dividends up to a level at which the marginal net nontax benefit of dividend payout is equal to the marginal tax detriment, measured in terms of the excess tax burden on dividends. To the extent the excess tax burden causes corporations to reduce their dividend payout ratios, it increases their cost of capital and results in a real decrease in corporate investment.

Note that a tax-induced reduction in dividend payout ratios is equally consistent with both views. There are, however, a number of indicators that suggest the rejection of the new view, or at least that the new view describes only a fraction of corporate dividend policies. The new view implies that corporations would not pay dividends if they could repurchase shares instead. Nevertheless, corporations can, and increasingly do, distribute earnings through share repurchases, while at the same time paying dividends.³⁹ “The new view is also inconsistent with the stability of dividend” distributions, notwithstanding dramatic changes over the last several decades in the tax rates applicable to dividends.⁴⁰ A further piece of empirical evidence is the practice of corporations paying dividends even as they issue new stock.⁴¹ If the new view

37. See Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference for Cash Dividends*, 13 J. FIN. ECON. 253 (1984). See also Sarig, *supra* note 33 (finding that the information content of an unexpected increase in dividends is stronger than an equal-size unexpected increase in share repurchases).

38. The optimal dividend payout ratio is presumably not 100% of earnings, because, at the margin, an increase in the dividend payout ratio also increases offsetting non-tax costs to the corporation. Notably, increased payment of dividends requires the satisfaction of the corporation's capital needs at the margin by the issuance of new debt or equity securities which increases transaction costs.

39. JANE G. GRAVELLE, *THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME* 87-88 (1994). Professor Grullon has observed the increasing use of share repurchases and the declining fraction of total earnings distributed as dividends. Nevertheless, his data shows large scale simultaneous use of both. Grullon, *supra* note 33, at 31 (citing COMPUSTAT, the Standard & Poor's database service, at <http://www.compustat.com>).

40. GRAVELLE, *supra* note 39 at 88; see also JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., *A HISTORY OF CORPORATE FINANCE* 18-19 (1997) (observing the stable pattern of corporations paying out roughly half of earnings as dividends, despite their taxability to individual recipients).

41. Jane G. Gravelle, *The Corporate Income Tax: Economic Issues and Policy Options*, in *TAX POLICY IN THE REAL WORLD* 15, 20 (Joel Slemrod ed., 1999).

were correct, this practice would be a sheer waste because it incurs an unnecessary excess tax burden on the distribution, and unnecessary transaction costs on the issuance of new stock. As such, it seems likely that the existence of the double tax regime does generate real distortions in economic decision making.

Another bias is the one the corporate tax creates in favor of debt capitalization, as opposed to the issuance of new equity. Because interest is deductible,⁴² debt capitalization effectively eliminates the corporate-level tax with respect to a portion of the corporate earnings stream.⁴³ The bias in favor of debt financing increases the risk of corporate bankruptcies. The increased risk of consequent bankruptcy transitions in ownership of corporate assets imposes very real net costs. The costs of bankruptcy are threefold. First,

42. I.R.C. § 163 (West 2003).

43. See ALI STUDY, *supra* note 12, at 25-28; TREASURY STUDY, *supra* note 12, at 6, 115; see also Polito, *Useful Fictions*, *supra* note 5, at 773-77 (discussing the effects of debt and equity financing on taxes). The ALI Study also observes that the corporate tax creates a similar bias in favor of financing via retained earnings as against the issuance of new equity. Whether financing by retention or by the issuance of new debt is preferable depends upon exact tax rates. See ALI STUDY, *supra* note 12, at 25-28. Because debtholders pay tax on interest or original issue discount as it accrues, and stockholder taxation can be deferred by retention, it is possible for a corporation to experience a tax benefit from capitalization with equity rather than debt. The after-tax rate of return for corporate equities of a corporation retaining earnings may be stated as follows:

$$R_R = r(1 - c)(1 - z)$$

where R_R is the after-tax rate of return of equity of a corporation that retains earnings, r is the pre-tax rate of return, c is the corporate tax rate, and z is the effective shareholder-level tax rate taking into account deferral and the preferential tax rates with respect to capital gains. *Id.* at 23-24. The after-tax rate of return for corporate debt may be stated as follows:

$$R_D = r(1 - p)$$

where p is the personal income tax rate. Given tax rates c and z sufficiently below p a corporation that retains earnings may have a lower effective tax on equity than on debt if:

$$(1 - c)(1 - z) > (1 - p)$$

Id. See, e.g., JANE G. GRAVELLE, CRS REPORT FOR CONGRESS, CORPORATE TAX INTEGRATION: ISSUES AND OPTIONS 11 (1991) (estimating that the difference between the total effective tax rates on debt and equity is about 50%). See also Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261, 266-68 (1977) (re-examining the tax advantages of debt financing). To the extent that the old view of dividend distributions is accurate and dividends are taxed at the ordinary rate p , it necessarily drives up the effective shareholder-level tax on equity, and shifts the equilibrium of tax rates to favor debt capitalization. Even the taxation of dividends at capital gains rates, as temporarily imposed by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64, does not eliminate the bias unless, at the margin, c is significantly lower than p . For a tax rate of 35% for interest income, and a 15% tax rate for dividends, equity is favored only for corporate tax rates below approximately 23.5%. Even for a tax rate of 40% for interest income, equity is favored only for corporate tax rates below about 29.4%. For most publicly traded corporations, the marginal corporate tax rate is 34%. I.R.C. § 11(b) (West 2003).

bankruptcy commonly involves the raising of new capital, which may be senior to the preexisting debt and equity. The risk of this subordination in bankruptcy reduces the value of corporate securities *ex ante*, and therefore raises the cost of capital to the corporation.⁴⁴ Second, there are the direct costs of bankruptcy: administrative expenses (legal fees, trustees' fees, et cetera) and time lost by corporate officers in litigation.⁴⁵

Perhaps the most important cost of bankruptcy proceedings is the negative effect that financial embarrassment may have on the stream of net operating earnings of the business firm. The firm may find it very difficult to obtain trade credit, customers may question its reliability and permanence as a source of supply and may choose to deal elsewhere. Questionable financial condition may be equivalent to negative publicity about the integrity of the firm.⁴⁶

Because "bankruptcy involves substantial administrative expenses and other costs, and causes a significant decline in the sales and earnings of the firm in receivership, the total value of the levered firm can be expected to be less than that of the all-equity company."⁴⁷ Therefore, the tax law's bias in favor of leverage reduces the value of corporate enterprises.⁴⁸ The Treasury's study of corporate tax integration concluded that corporate debt levels have grown significantly since the end of the Second World War, and particularly quickly during the 1980s.⁴⁹

The third bias, commonly seen as the most obvious bias, of the double tax regime is its bias against investment in corporate capital.⁵⁰ Because the return

44. See Nevins D. Baxter, *Leverage, Risk of Ruin and the Cost of Capital*, 22 J. FIN. 395, 398 (1967).

45. *Id.*

46. *Id.* at 399.

47. *Id.* at 397.

48. Focusing solely on the bankruptcy costs of debt would lead to the conclusion that, in the absence of corporate taxes, corporations would use no debt financing at all. Given that this has never been the historic practice, it must be that debt financing generates other nontax benefits as well. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 479-97 (5th ed. 1996); HAROLD BIERMAN, JR., *STRATEGIC FINANCIAL PLANNING: A MANAGER'S GUIDE TO IMPROVING PROFIT PERFORMANCE* 45-51 (1980). Nevertheless, it is clear that the presence of the double tax does increase the bias in favor of debt financing.

49. TREASURY STUDY, *supra* note 12, at 7.

50. For the earliest studies of this effect, see Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962); Arnold C. Harberger, *Efficiency Effects of Taxes on Income from Capital*, in *EFFECTS OF CORPORATION INCOME TAX* (Marian Krzyzaniak

to investments in corporate form bears a higher tax burden than does investment in noncorporate form, the cost of capital for corporate form investment is, *ceteris paribus*, higher than the costs of capital for other sectors.⁵¹ This distortion in relative capital costs biases capital flows against

ed., 1966).

51. The cost of capital is calculated in terms of before-tax rates of return that yield the after-tax rates of return that the market demands of an investment. Consider two projects, one in corporate form and the other in noncorporate form, of which the financial market demands an equal after-tax rate of return, which is denoted here at r . Let p be the effective rate of personal income taxation, c be the effective rate of corporate income taxation, R_n the required before-tax rate of return for noncorporate investment, and R_c the required before-tax rate of return for corporate investment. If the corporation distributes all of its earnings as earned, the required before-tax rates of return may be determined as follows:

$$R_n = r/(1 - p)$$

$$R_c = r/(1 - c)(1 - p)$$

resolving the equations against one another yields R_c in terms of R_n :

$$R_c = R_n/(1 - c)$$

The corporate cost of capital is higher than the noncorporate cost of capital for all positive corporate tax rates. According to a 1991 Congressional Research Service study, the effective combined federal tax rate (including both corporate and personal tax) on corporate equity was 48%, compared with 28% for noncorporate equity. See GRAVELLE, *supra* note 43, at 11. These estimates allow one to calculate the relative costs of capital. The estimates of the tax rates tell us that:

$$(1 - c)(1 - p) = (1 - .48) = .52$$

$$(1 - p) = (1 - .28) = .72$$

Resolving these two equations against one another yields $(1 - c) = .72$. Therefore, $R_c = R_n/.72$; $R_c \approx 1.38 \cdot R_n$. As of the 1991 study, the corporate cost of equity capital was roughly 138% of the noncorporate cost of equity capital.

One indication of the effect of this bias is to compare the spread on pretax rates of return on corporate investments and the cost of funds in the United States and other countries. A 1991 OECD study compared this "tax wedge" in the United States and five other industrialized democracies for manufacturing investments.

Country	Corporate Tax Wedge (measured in basis point)
Canada	120
France	40
Germany	60
Japan	140
United Kingdom	90
United States	80

See TREASURY STUDY, *supra* note 12, at 6.

Open economy models raise a serious question of whether the burden of the tax is shifted

capital investment in corporate form.

The extent in practice to which the double tax regime biases the market against corporate capital, however, depends in part upon the degree of descriptive validity that attaches to the so-called "new view" or "traditional view" of dividend policy. Because the new view holds that there is no benefit in the financial market for distributing dividends, it suggests that corporations mitigate the double tax by retaining earnings except to the extent they lack investment opportunities that are justified by the opportunity cost of capital. As such, the excess tax burden on distributed earnings over retained earnings is a pure transfer from shareholders to the fisc, with no real effect on corporate investments. As such, policy discussion should focus on the double taxation of retained earnings. Because the effective tax rate on capital gains is quite low, the extent of the allocative bias is reduced. In fact, if this view is correct, the very existence of a double tax burden in practice depends upon whether the effective combined corporate tax and shareholder capital gains tax is greater than a single level of tax imposed on noncorporate capital.⁵²

away from capital. In a small open economy in which capital is perfectly mobile and goods in international trade are perfect substitutes for one another, the burden of the tax is shifted to immovable factors of production; for example, to labor. In such an economy, the price of goods is fixed in the international market and capital migrates abroad to the extent necessary to raise the domestic after-tax rate of return to capital to that available in international markets. Therefore, after-tax labor wages must fall to clear the market. If, however, goods are not perfect substitutes and capital is not perfectly mobile, as seems a more accurate description of reality, at least a portion of the tax burden does fall on capital. See Jane G. Gravelle, *Corporate Tax Incidence in an Open Economy*, in PROCEEDINGS OF THE EIGHTY-SIXTH ANNUAL CONFERENCE ON TAXATION 173 (Frederick D. Stocker ed., 1994); GRAVELLE, *supra* note 39, at 232.

52. The after-tax rate of return for corporate equities of a corporation distributing its earnings annually as earned may be stated as follows:

$$R_c = r(1 - c)(1 - d)$$

where r is the pre-tax rate of return, c is the corporate tax rate, and d is the tax rate applicable to dividends. The after-tax rate of return for corporate equities of a corporation retaining earnings may be stated as follows:

$$R_R = r(1 - c)(1 - z)$$

where R_R is the after-tax rate of return of equity of a corporation that retains earnings, and z is the effective shareholder-level tax rate taking into account deferral and the preferential tax rates with respect to capital gains. With effective deferral, $z < d$ even if d is set equal to the nominal capital gains tax rate. ALI STUDY, *supra* note 12, at 23-24. The non-corporate after-tax rate of return may be stated as follows:

$$R_N = r(1 - p)$$

Given tax rates c and z sufficiently below p , a corporation retaining earnings may create a bias in favor of its equity as against noncorporate equity if:

$$(1 - c)(1 - z) > (1 - p)$$

Id. For purposes of illustration, set c equal to 35% and p equal to 40%. See I.R.C. § 1(a), § 11(b) (West 2003) (listing personal and corporate tax rates based on taxable income). The effective combined tax on non distributing corporate equities is less than the effective tax on noncorporate

In contrast, the traditional view holds that there is a real nontax benefit to the distribution of dividends. Because shareholders require a lower rate of return from equities on which dividends are regularly paid, corporations are able to reduce their cost of capital by regular dividend distributions.⁵³ If this view is correct, corporations will pay dividends up to a level at which the marginal benefit of dividend payout, in terms of reducing the cost of capital, is equal to marginal detriment, in terms of the excess tax burden on dividends.⁵⁴ As such, corporations do not escape the excess tax burden on distributed earnings to the same degree as if the new view is accurate. To the extent this causes corporations to reduce their dividend payout ratios, it increases their cost of capital and results in a real decrease in corporate investment.

It may be that mature firms are able to fund capital needs through debt and retention of earnings, but new and rapidly growing firms are commonly constrained to raise capital through the issuance of new equity.⁵⁵ It seems clear that the corporate income tax does make the cost of equity capital higher than the cost of other forms of capital.⁵⁶ Therefore, the corporate tax does create a real bias against corporate enterprise, and it is one that falls particularly upon growing firms.

Any such distortion would be trivial, however, if capital could migrate costlessly from corporate form to some other form of business organization. That corporate form continues to thrive for publicly traded enterprises⁵⁷ in the face of the double tax, and that those corporations continue successfully to issue new corporate equities in the public market suggests there are real advantages to corporate form that cannot be replicated in some other form. Equivalently, the costs of abandoning corporate form must exceed the excess burden of the double tax regime.

equities if z is less than 8%. For most taxpayers, the maximum capital gains tax rate has been 20%, I.R.C. § 1(h) (West 2003), and the 2003 Tax Act temporarily reduces the maximum capital gains rate to 15%, Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301, 117 Stat. 752, 758. Z is dependent upon the length of deferral and the discount rate at which deferral is valued. See *supra* note 43.

53. See *supra* notes 33-38 and accompanying text.

54. Even taxing dividends at nominal capital gains rates does not eliminate the excess tax burden on corporate equity relative to noncorporate investment unless the corporate tax rate is significantly below the individual ordinary tax rate. See *supra* note 43.

55. GRAVELLE, *supra* note 39, at 87; Peter Birch Sorensen, *Changing Views of the Corporate Income Tax*, in *TAX POLICY IN THE REAL WORLD* 27, 31 (Joel Slemrod ed. 1999).

56. Alan J. Auerbach, *Taxes, Firm Financial Policy and the Cost of Capital: An Empirical Analysis*, 23 J. PUB. ECON. 27 (1984).

57. Closely held businesses are largely able to gain whatever nontax advantages accrue to them from corporate form, and also to avoid the excess tax burden of the double tax regime. See Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

Several explanations have been advanced for this failure of capital to migrate away from corporate form. Size allows for economies of scale, and widely dispersed ownership may facilitate assembling the capital necessary to achieve those scale economies.

But given that some enterprises are large, why should they have more than a very small number of owners? The answer here appears to involve a number of factors: diversification of risk, the desire to limit liability, information costs of becoming fully informed about all the activities of a large enterprise, and liquidity. These reasons for multiple owners are interrelated. For example, it may be very difficult for any one owner to become fully informed about a large firm's activities, but the lack of full information may make investing in a large firm riskier. The limits on full information provide investors with a further interest in reducing their exposure in a particular firm, including limiting their liability.⁵⁸

The corporate characteristics—limited liability, free transferability of interests, centralized management, and continuity of existence—no doubt facilitate the dispersed capital ownership structure⁵⁹ of the so-called Berle-Means corporation.⁶⁰

A slightly different explanation for why the size of a corporation may be important is the possibility that, even within the same industry, consumers may not regard the goods produced by large businesses as fully equivalent to those produced by small businesses. A large business's goods and services may have the advantage of uniformity and reliability, while small businesses may have

58. Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749, 757 (1989).

59. See ROBERT C. CLARK, *CORPORATE LAW* 2 (1986) ("These four characteristics all serve the positive functions of greatly facilitating the efficient aggregation of very large amounts of capital from numerous investors and the efficient operation of a very large business with numerous owners and employees.").

60. See *supra* note 34. While these characteristics may be necessary to effect the separation of ownership and control, they may not be sufficient. Professor Roe has hypothesized that the dominance of the Berle-Means corporation in the United States is unsupportable in a social democracy in which government social policy serves to magnify, rather than reduce, the difficulty of aligning managerial interests with shareholder interests. See Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

greater flexibility in adapting goods and services to local tastes.⁶¹ A third possibility is that corporate and noncorporate securities are imperfect substitutes in investment portfolios.⁶²

The rise in the 1980s of the master limited partnership issuing publicly traded limited partner "units"⁶³ underscores the real economic costs incurred by the loss of corporate form. The master limited partnership represented an attempt to capture functionally all of the economic benefits⁶⁴ of a widely held

61. See DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 50 (1993); Jane G. Gravelle & Laurence J. Kotlikoff, *Corporate Tax Incidence and Inefficiency when Corporate and Noncorporate Goods are Close Substitutes*, 31 ECON. INQUIRY 501, 504 (1993).

62. See Jane G. Gravelle & James B. Mackie III, *The Real and Financial Efficiency Gains from Corporate Tax Integration: Results from Three Simulation Models*, in PROCEEDINGS OF THE EIGHTY-FOURTH ANNUAL CONFERENCE ON TAXATION 140, 142 (1992).

63. See William M. Gentry, *Taxes and Organizational Form: The Rise and Fall of Publicly Traded Partnerships*, in PROCEEDINGS OF THE EIGHTY-FOURTH ANNUAL CONFERENCE ON TAXATION, 30 (1992); Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 502-03 (1995).

64. Formally, a master limited partnership would have no more than two of the four corporate characteristics, thereby achieving partnership classification under the predecessor to the check-the-box regulations. In practice, however, the deviation from true corporate structure did not bear anything like the economic impact that the paradigmatic partnership characteristics suggest. Formally speaking, such master limited partnerships normally lacked limited liability and continuity of life. Lack of limited liability was achieved by the introduction of a corporate general partner bearing unlimited liability that satisfied the then-applicable standards of an adequately capitalized corporate general partner. The I.R.S. was willing to issue an advance ruling on lack of limited liability if the general partner's net worth was at least 10% of the capital contributed to the master limited partnership. But much of the tax bar was willing to opine favorably on the absence of limited liability so long as the general partner had "substantial assets" unrelated to the master limited partnership. Lack of continuity of life was achieved by causing the bankruptcy of the corporate general partner to trigger the dissolution of the entity under state law. Given an adequately capitalized corporate partner, this formal lack of these two corporate characteristics did not bear anything like the economic bite of the paradigmatic unlimited liability and lack of continuity of life of the partnership model of business organization. Some such master limited partnerships also asserted lack of free transferability on the premise that transfers required the consent of the corporate general partner. Nevertheless, the public trading of their limited partnership "units" generally ensured that they had the corporate characteristic of freely transferable interests. All such master limited partnerships had the corporate characteristic of centralized management. See R. Donald Turlington & Reba A. Beeson, *Master Limited Partnerships Current Issues, Techniques and Strategies*, in PARTNERSHIP TAXATION 1988: AN ADVANCED PROGRAM, 211, 228-30 (1988). See also STAFF OF JOINT COMM. TAXATION, 100TH CONG., TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS 28 (1987) ("Those who support proposals to change the classification of MLPs argue that publicly traded limited partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity.").

corporation in a legal package that the tax law would exclude from the double tax regime. The addition of section 7704 to the Internal Revenue Code, which treats publicly traded partnerships as corporations for tax purposes, served to arrest this development.⁶⁵ To the extent that section 7704 is effective,⁶⁶ it ensures that capital migration from corporate legal form is pointless, because any business form that is functionally substitutable for the widely held corporation is a widely held corporation for tax purposes.

The last bias of the double tax regime is the extent to which it increases the income tax's overall bias against capital formation. The income tax generally creates a bias against capital formation because it distorts the time value of money.⁶⁷ To the extent that the excess tax burden of the double tax regime falls on the return to capital, it increases the distortion in the after-tax time value of money. The degree of the distortion in capital formation depends both on the spread between before-tax and after-tax rates of return ("spread") and on the sensitivity of savings to changes in the after-tax rate of return. Although the spread is well documented, the responsiveness of savings to rate of return distortions has not been conclusively established.⁶⁸ Therefore, the extent of the distortion in savings rates is unclear.

The extent of the harm arising from these distortions is an empirical question. It is always possible for some economic distortions to mitigate others.⁶⁹ The bias in favor of debt financing, and in the corporate decision to distribute dividends, partially mitigates the bias against corporate form. Nevertheless, it seems clear that some net distortion remains.

The Treasury Study published in 1992 estimated that even its partial integration proposals would increase national economic welfare between \$2.5 billion and \$25 billion per year.⁷⁰ An earlier study estimated efficiency gains of full integration on both annual and long-term present value bases. Expansion of national income for a single year might be as much as \$11 billion

65. See Hobbs, *supra* note 63, at 508-9.

66. A significant limitation on its effectiveness is the exception for publicly traded partnerships whose gross income is at least 90% "qualifying income," I.R.C. § 7704(c) (West 2003), which includes not only passive investment income, but also income from real estate dealings and natural resource related activities, *Id.* § 7704(d). In addition, grandfathered publicly traded partnerships continue to avoid the full effect of corporate tax classification by submitting to an annual tax of 3.5% of gross income. *Id.* § 7704(g).

67. See Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996).

68. See TREASURY STUDY, *supra* note 12, at 11-12, 118.

69. See *supra* note 4.

70. TREASURY STUDY, *supra* note 12, at 111, 129-41. Presumably this estimate is made in terms of 1992 dollars. In 2000 dollar equivalents, these figures are approximately \$2.9 billion to \$29 billion. These inflation-adjusted figures are based on the gross domestic product (GDP) implicit price deflator. See ECONOMIC REPORT OF THE PRESIDENT 278 (2001).

(1973 dollars). The present value of the increased future stream of national income might be as much as \$551 billion (1973 dollars), compared to an estimated \$49 trillion (1973 dollars) present value of the future income stream of the U.S. economy. These figures contained some sensitivity to the manner in which government revenue losses from tax integration are replaced.⁷¹

Dr. Jane Gravelle, a senior specialist in economic policy for the Congressional Research Service, estimated the incremental welfare distortions of the various biases induced by the excess-burden of the double tax as a percentage of annual domestic consumption.⁷² The bias against corporate capital generates annual welfare losses of 0.9% of consumption, dividend bias generates losses of 0.2%, and debt-equity bias generates losses of 0.17%, which sum to 1.27%.⁷³ Based on contemporary consumption figures, this amounts to roughly \$82 billion.⁷⁴ For comparison, she estimates that the total incremental tax revenue of the double tax regime over a fully integrated regime amounts to only 1.38% of consumption, only slightly greater than the welfare loss generated by the tax, which makes the double tax regime a fairly inefficient source of government revenue at the margin.⁷⁵

71. Don Fullerton et al., *Corporate Tax Integration in the United States: A General Equilibrium Approach*, 71 AM. ECON. REV. 677, 686-88 (1981). Adjusted to 2000 dollars, these figures for efficiency gains are \$35 billion dollars on an annual basis and \$1.8 trillion in present value terms. The latter would be compared to \$158 trillion present value of the overall future income stream. These inflation-adjusted figures are based on the GDP implicit price deflator. See ECONOMIC REPORT OF THE PRESIDENT 278 (2001). Of course, after thirty years these estimates should not receive excessive reliance, given that they may be dependent upon assumptions that were validly descriptive of the economy at the time but are no longer.

72. GRAVELLE, *supra* note 39, at 89-90.

73. *Id.* at 75-90. Dr. Gravelle also estimated that a switch to full partnership method taxation of corporations would reduce welfare losses by another 0.06% of consumption via a reduction in the lock-in effect. Such an effect is the result of pass-through taxation increasing the basis in shares, and therefore reducing the lock-in effect of taxpayers declining to sell shares to avoid capital gains taxation. *Id.* at 89.

74. This figure is based on annual consumption of \$6,443.9 billion, which reflects consumption for the third quarter of 2001 annualized to full year figures. See ECONOMIC REPORT OF THE PRESIDENT 322 (2002).

75. GRAVELLE, *supra* note 39, at 81. Professor David Weisbach has proposed a useful practical step of comparing tax rules in terms of their marginal efficiency cost of funds (MECF). The MECF of any tax rule would be the deadweight loss per marginal dollar of revenue. Under his analysis, a tax rule would be rejected if its MECF was greater than the existing average MECF. The result would be a tendency to accept rules that reduce the average MECF and reject those that would increase it. See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1665-75 (1999). In terms of MECF, the double tax regime does not appear to be a strong candidate for survival.

B. Distributive Equity

The double tax regime can also be faulted for its distributional effect, in terms of both vertical equity and horizontal equity.⁷⁶ The existence and nature of its distributional effect, however, depends not only upon the acceptance of value judgments that are not susceptible of proof, but also the determination of the actual incidence of the excess tax burden associated with the double tax regime. In the end, the greatest distributional fault of the double tax regime is that the indeterminacy of its incidence renders any judgment about distributional effects unjustifiable guesswork.

Consider first the vertical equity analysis. In the short-term, the imposition of the corporate income tax was most likely borne by the holders of corporate equity.⁷⁷ To the extent that equity ownership is positively correlated with some measure of economic well-being,⁷⁸ one might regard this short-term effect as a benign increase in the progressivity of the income tax regime. The distribution of beneficial ownership of corporate shares is far from clear,⁷⁹

76. Horizontal equity is the requirement that equals be treated alike. Vertical equity is the requirement of an appropriate pattern of differentiation among unequals. See Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 140-41 (1989); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990). Professor Kaplow has argued that horizontal equity has no independent significance apart from vertical equity, in that any regime that makes only appropriate distinctions among unequals will also necessarily treat equals alike. Kaplow, *supra*, at 141. This issue has been the subject of ongoing analysis. See Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993).

77. CONGRESSIONAL BUDGET OFFICE, *THE CHANGING DISTRIBUTION OF FEDERAL TAXES: 1975-1990* 22 (1987).

78. See Polito, *Useful Fictions*, *supra* note 5, at 767-68.

79. A high percentage of shares are held by institutional investors such as pension funds, insurance companies (including mutual insurance companies), mutual funds, and charitable organizations. By 1990, institutional investors held 53% of all corporate equity. See Robert S. Frenchman, *The Recent Revisions to Federal Proxy Regulations: Lifting the Ban on Shareholder Communications*, 68 TUL. L. REV. 161, 175 (1993) (citing COLUMBIA INSTITUTIONAL INVESTOR PROJECT, CENTER FOR LAW AND ECONOMIC STUDIES, *INSTITUTIONAL INVESTORS AND CAPITAL MARKETS* 1991) (Columbia Univ. Sch. of Law 1991). A breakdown by type of institution is as follows:

however, and the assumption that the double tax regime increases progressivity is far from established (even in the short-term). In the long-term, it seems clear that at least some of the double tax regime's burden shifts to capital other than corporate equity, or labor, or both.⁸⁰ The more widely dispersed the economic

<u>Institution Type</u>	<u>Equity Holdings (In billions)</u>	<u>Percentage of U.S. Equity Market</u>
Pension Funds:		
Private	\$679.3	19.9%
Public (state and local)	<u>282.5</u>	<u>8.3%</u>
Total Pension Funds	961.8	28.2%
Mutual Funds	\$245.8	7.2%
Insurers (Life and Casualty)	\$235.7	6.9%
Bank Trusts	\$314.0	9.2%
Foundations / Endowments (Colleges and Universities)	<u>\$61.7</u>	<u>1.8%</u>
	\$1819.00	53.3%

John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 848 (1994). These organizations invest for the benefit of a large number of individuals who are not necessarily in the highest income tax brackets.

80. The assumptions one makes as to capital mobility are crucial for predictions of the corporate income tax's incidence. If the supply of savings is unaffected by the imposition of that tax:

The *corporation income tax* depresses rates of return in the corporate sector when it is imposed, but this encourages some capital to move to the noncorporate sector, where rates of return after tax are initially higher. As the supply of capital in the non-corporate sector increases, rates of return decline there, and this continues until net returns after tax are the same in both sectors. Thus the after-tax earnings of all capital are reduced even though the corporation income tax is imposed only on capital employed in the corporate sector. Furthermore, assuming that the total supply of saving is fixed, the earnings of labor remain unchanged, and capital bears the entire tax.

JOSEPH A. PECHMAN & BENJAMIN A. OKNER, WHO BEARS THE TAX BURDEN? 31 (1974) (footnote omitted). On the other hand:

If savings decline in the face of a corporate tax, some of the burden may fall on workers through lower wages. This occurs because as savings decline there is less new investment. The stock of capital grows more slowly and productivity declines because workers must use older, fewer, and less technologically advanced tools and machines. Because wages are linked to productivity, labor income bears some of the corporate tax burden.

Even if there is no decline in savings, workers may bear some of the

incidence of the tax is, the weaker the assertion that the double tax regime increases the progressivity of the tax burden, and the weaker the assertion that it improves the vertical equity of the tax system.⁸¹

Next, consider horizontal equity. All assertions about horizontal equity have a conclusory nature to them, because, as Professor Westen observed:

The formula “people who are alike should be treated alike” involves two components: (1) a determination that two people are alike; and (2) a moral judgment that they ought to be treated alike. The determinative component is the first. Once one determines that two people are alike for purposes of the equality principle, one knows how they ought to be treated.⁸²

Notwithstanding this conclusory nature, one might attempt reasonably to justify the double tax regime’s horizontal equity implications. The proffered justifications are premised on the view that participants in corporate and noncorporate enterprise are not equals—presumably because legal structures confer some form of subsidy on corporations subject to the double tax regime—and that the excess burden of the double tax appropriately adjusts the tax burden for that inequality. This last proposition, however, is highly contestable.

Traditionally, the excess burden of the double tax regime could be seen as an appropriate charge for the benefits of corporate characteristics, especially limited liability. A horizontal equity case premised on the conferral of corporate characteristics via the corporate charter is subject to arguments that the

burden of the corporate income tax if the tax leads to a reduction in domestic investment. Because capital is thought to be mobile internationally, high corporate taxes could cause investors to take their money overseas (or, alternatively, discourage foreign investment in this country). But workers would not bear the full burden unless international capital markets were free and open and there were no offsetting changes in taxes on investment in foreign countries.

CONGRESSIONAL BUDGET OFFICE, *supra* note 77, at 22-23 (footnotes omitted).

81. Reference to the double tax increasing or decreasing the progressivity of the income tax begs the question of what degree of progressivity is desirable. It also begs the question of what is the appropriate index—for example, income, consumption, or wealth—against which to measure that progressivity. See McDaniel & Repetti, *supra* note 76, at 613 (“[T]here is no independent content to V[ertical] E[quity] and resort must be had to economic assumptions and a theory of justice to provide that content . . .”). Those issues, however, are beyond the scope of this article. See WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953).

82. Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537, 543 (1982).

government does not confer on corporations a subsidy relative to other forms of business enterprise.⁸³ To that extent, the excess burden of the double tax regime definitionally violates the principle of horizontal equity. Moreover, given the large number of business entities that enjoy all of the characteristics

83. The corporate form confers the following four attributes: centralized management, free transferability of interests, legal personality, and limited liability. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991) (analyzing the governance of a corporation as a contract among its investors and managers). The first three attributes can all be seen as reflecting a contract that investors would draft among themselves, were it not for the high bargaining costs among members of a dispersed group. See *id.* As such, corporate form represents not a subsidy, but a facilitation of the result that would occur in a frictionless market. See *id.*; see also Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261-62 (1982) (discussing the logical formation of “the firm”); Jensen & Meckling, *supra* note 36, at 311 (discussing contractual relationships of a firm). Shareholders could achieve much the same result without the aid of the legislature by contracting to govern their relations according to the Model Business Corporations Act.

Limited liability may also be viewed as the welfare maximizing contractual term all market participants would accept if they were able to negotiate frictionlessly. See EASTERBROOK & FISCHEL, *supra*, at 40-62.

Because limited liability increases the probability that there will be insufficient assets to pay creditors’ claims, shareholders of a firm reap all of the benefits of risky activities but do not bear all of the costs. These are borne in part by creditors. Critics of limited liability have focused on this moral hazard—the incentive created by limited liability to transfer the cost of risky activities to creditors—as a justification for substantial modification of the doctrine. . . .

. . . The implications of this point, however, are unclear, both because modifying limited liability has its costs and because moral hazard would exist without limited liability. The social loss from reducing investment in certain types of projects—a consequence of seriously modifying limited liability—might far exceed the gains from reducing moral hazard. Too, even the abolition of limited liability would not eliminate the moral hazard problem. The incentive to engage in over risky activities exists whenever a person or firm has insufficient assets to cover its expected liabilities. Although the problem of moral hazard may be more severe under limited liability, it exists under any rule

. . . At all events, the magnitude of the externality under limited liability has been exaggerated. As Richard Posner has demonstrated, there is no externality with respect to voluntary creditors. In addition, firms have incentives to insure for amounts greater than their existing capital. The insurance company becomes a contract creditor, reducing the externality.

Id. at 49-50 (footnotes omitted). Limited liability makes possible the large assemblages of capital upon which industrial capitalism depends for economies of scale. These scale economies may sufficiently increase economic welfare that, in a frictionless bargain, all would accept the possibility of limited recovery in exchange.

of corporate form but are not subject to the double tax regime,⁸⁴ it is not possible to conclude that capturing the benefits of corporate characteristics is the justification for the existing double tax regime in terms of horizontal equity or otherwise.⁸⁵

An alternative justification is to premise the double tax as compensating for the government's role, chiefly through securities regulation, in maintaining the confidence and stability of public equity markets. It does seem at least plausible that the government's securities market regulatory role, in facilitating access to public sources of equity, is valuable to publicly traded corporate enterprises.⁸⁶ It is important to note, however, that this increased value should ultimately reflect itself in increased taxable income for investors in the corporate enterprise. A fully integrated income tax would capture at least a portion of that benefit. It is true that the excess burden of the double tax regime may serve to capture a portion of that benefit not otherwise captured by an integrated income tax. On the other hand, the increased income reflecting other government benefits is also captured only in part by income taxation. Capturing a further portion of the benefit of liquid equity markets through a second tax, but not doing likewise for other government provided benefits, makes a fairly weak horizontal equity case.

Even an inquiry confined to the benefit of securities markets makes a weak horizontal equity case. As Professor Schlunk has pointed out, there are a substantial number of firms that access the public equity markets without being subject to double taxation, and no double tax is imposed for access to the public debt markets.⁸⁷ The selective application of the existing double tax regime means that its horizontal equity cannot be justified in terms of capturing the benefits of public markets.

Professor Schlunk advances an additional justification for an entity tax, which he would structure quite differently from the existing double tax regime,

84. See *infra* notes 135-138 and accompanying text.

85. See, e.g., Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 341-42 (2003).

86. See, e.g., LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 217-18 (3d ed. 1998) ("[I]ncreasing investor confidence . . . may have important economic consequences. By reducing the perceived risk of corporate securities, compulsory disclosure would tend to reduce the risk premia that issuers . . . would have to pay, thus increasing the funds available for economic growth."); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 561-62 (rev. ed. 1995); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115-20 (1985).

87. See, e.g., Schlunk, *supra* note 85, at 345-47.

premised on the theory of the firm. He argues that, to the extent individuals choose to conduct business within the form of an entity rather than as a series of separately negotiated contracts, there must be some incremental benefit to the existence of a firm, as such.⁸⁸ He proposes an entity-level tax that is designed to capture the benefit of conducting business as an entity.⁸⁹ He identifies an entity with its capital investors, including investors of human capital, for purposes of constructing the entity's taxable income.⁹⁰

It seems very likely that the benefits of conducting enterprises as firms fall to far more individuals than the capital participants of those firms. Net efficiency gains may be shared as increased wages or reduced prices for goods. From the perspective of horizontal equity, an entity tax that captures a portion of that benefit from some beneficiaries, but not others, is problematic. Moreover, if the benefits of conducting enterprises as firms are distributed far more broadly than to the enterprise's capital participants, the horizontal equity justification for capturing a portion of those benefits through taxation for redistribution through government action, as opposed to accepting the broad distribution of those benefits through market operations, is far from obvious. Professor Schlunk recognizes this possibly broader definition of participation in business entities, but sets it aside based on administrative concerns and his view that these benefits are only incidental.⁹¹

Regardless of how one defines the beneficiaries of the existence of firms, from the perspective of horizontal equity analysis, this benefit theory of a double tax regime faces a problem that confronts the justification premised on access to public equity markets. Even if the operation of a business in an entity is a government conferred benefit, that benefit should reflect itself in the incomes of the individual participants. As in the justification of double taxation premised on access to public equity markets, a fully integrated income tax would capture at least a portion of that benefit. Here again, capturing a further portion of the benefit through a second tax, but not doing likewise for other government provided benefits, makes a fairly weak horizontal equity case. In any case, Professor Schlunk does not advance this theory to justify the existing double tax regime, but rather to create a rational basis for a quite different double tax regime.

In the case of the existing double tax regime, the entire issue of equity is further complicated because the question of whether the actual incidence of the excess burden of the double tax regime is on equity investors cannot be

88. *Id.* at 359–62 (citing Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1987)).

89. *See, e.g., id.* 363–64.

90. *Id.* at 367–82.

91. *Id.* at 367–70.

answered with any degree of reliability.⁹² In terms of vertical equity, uncertain tax incidence makes it impossible to judge the actual progressivity of the overall combination of tax regimes in use. Moreover, indeterminate incidence further eviscerates the reliability of even the contestable case of a horizontal equity justification. Without knowing who bears the excess burden of the double tax, one cannot judge whether it mitigates or exacerbates the disparity of treatment of equals. The uncertainty of incidence confuses the very process of tax policy making. Because the incidence of the corporate tax is uncertain, policy makers are unable to judge the incidence of changes in the corporate income tax with any degree of certainty. That uncertainty hampers the necessary inquiry into the relative distributional effect of any given package of corporate and individual tax law changes.⁹³

III. PREMISES AND CONDITIONS OF THE LAISSEZ-FAIRE APPROACH

Given the economic distortions of the classical tax system,⁹⁴ the relatively high marginal efficiency cost of funds of the incremental revenue generated by the excess tax burden on corporate earnings,⁹⁵ and the tenuous case for classical taxation based on distributive equity concerns,⁹⁶ an idealized income tax would exactly eliminate the excess tax burden by treating all business entities as fiscally transparent. The contribution of the Laissez Faire Approach to this discourse is to advance the integrationist agenda while working within the existing tax law, without creating significant new tax regimes or significantly reworking existing regimes. The premises that justify the Laissez Faire Approach, and the conditions for its implementation, are described briefly.

A. *Idealized Tax Integration is Not Attainable in Reality*

An idealized integrationist paradigm of taxation would fully eliminate the disparities of double taxation. Such an idealized tax paradigm would eliminate the disparate tax treatments between (1) corporate and noncorporate form, (2) debt and equity, (3) distributed earnings and retained earnings, and (4) realizations as distributions and as dispositions. Under such an idealized regime, all income would be imputed to individuals connected with the

92. See *supra* notes 80-81 and accompanying text.

93. Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 640-47 (1995).

94. See *supra* Part II, section A.

95. See *supra* notes 70-75 and accompanying text.

96. See *supra* Part II, section B.

corporate enterprise—as shareholders or otherwise—as earned, and all income would be taxed at the individual rate schedules.

In principle, the nearest one might come to such a perfect regime is the fiscal transparency of a full pass-through regime. Under such a tax regime, there would be no corporate-level tax. Instead, all of the revenue of the corporation would be taxed as income of some individual. The nearest analog is the tax treatment of partnerships.⁹⁷

As a practical matter, the full realization of that paradigm is not feasible because of a number of serious practical issues. How is the pool of undistributed corporate earnings, against which no shareholders have specifically enforceable legal claims, to be allocated among individual investors? As a practical matter, how are corporations accurately to allocate undistributed earnings to individual shareholders if the shares change hands frequently on public markets? How are earnings to be allocated among multiple classes of stock? Is it possible to allocate earnings through multiple tiers of corporations to the ultimate individual shareholders in a manner that is sufficiently timely to allow the filing of annual returns? Who will bear the costs of corporate-level audit adjustments when the beneficial ownership of the stock may have changed many times in the interim?⁹⁸ This list is formidable, and it does not even address questions common to all integration programs.⁹⁹

The Bush Administration's original proposal,¹⁰⁰ while not a full pass-through model, would have entailed many of the complications of the full-partnership paradigm. The Bush Administration hoped to avoid not only double taxation of distributed earnings, but also a second tax to the extent that the sales price of corporate stock reflects retained earnings previously taxed at the corporate level. As such, that proposal, like a partnership model, would have required the allocation of undistributed earnings among shareholders for tax purposes, which would have required the resolution of all of the subsidiary questions that entails. Even given the possibility of administratively feasible compromises, the prevailing view appears to be that the cost in legal

97. See I.R.C. §§ 701-777, 6221-6234 (West 2003). In practice, fiscal transparency cannot be effected in a manner that fully eliminates all distinctions between a business conducted directly as an individual's sole proprietorship and an enterprise conducted through a legal structure. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K* (2d ed. 2000). Nevertheless, the partnership paradigm appears to be the nearest alternative possible to the integrationist ideal.

98. Each of these concerns demands some deviation from the full integration ideal in order to make the system administrable in any sense. See Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL'Y 1009 (1989).

99. See, e.g., TREASURY STUDY, *supra* note 12, at 61-92.

100. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 11-22 (2003).

complexity and administrative and compliance burdens make a fully integrated system impracticable at best.¹⁰¹

In the alternative, some simple responses to the integration problem are available, but they are dismissed so easily that they might be regarded as trivially wrong. The first easily dismissed proposal is the abolition of the corporate-level tax with no changes to the shareholder-level tax. This step would certainly eliminate the excess burden of the double tax regime. The simple elimination of the corporate-level tax, however, would press the inside shelter to its ultimate form. There would be no tax at all on corporate earnings until distributed as dividends or realized as gain on share dispositions. The consequences of this are clear: the bias against dividend distributions¹⁰² would be greatly exaggerated. Debt securities, which are subject to current economic accrual under the original issue discount rules,¹⁰³ would not create the same deferral benefit available to equity holders, and equity capitalization's lack of interest deductions¹⁰⁴ would be costless to nontaxable corporations. As such, bias against equity capitalization would be replaced by a bias in favor of equity capitalization.¹⁰⁵

On the other hand, in the absence of a truly effective regime to compel the distribution of earnings,¹⁰⁶ the mitigation of capital taxation through the

101. See, e.g., TREASURY STUDY, *supra* note 12, at 17.

102. See *supra* notes 15-41 and accompanying text.

103. I.R.C. §§ 1272-1275A (West 2003).

104. *Id.* § 163.

105. Leverage can have the beneficial effect of imposing discipline on corporate management, see example in Jensen, *supra* note 35, at 323 (citations omitted), and of signaling firm value to the equity market, see Wayne H. Mikkelsen & M. Megan Partela, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31 (1986). As such, leverage levels below a firm's optimal level of leverage can themselves be harmful.

106. Existing tax law does contain mechanisms designed to place an outer limit on the use of corporations to minimize shareholder tax burdens through the retention of earnings. Even under the existing regime, however, they are not as fully effective in enforcing the shareholder-level tax as might appear from a superficial examination. In a regime without a corporate-level tax, the enforcement stress they would bear would be far greater.

At present, the accumulated earnings tax is the primary mechanism to minimize this form of shareholder-level tax avoidance. I.R.C. §§ 531-537 (West 2003). See generally BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 7.01-7.09 (7th ed. 2000 (with updates through 2002)) (discussing a corporation's potential for tax avoidance). With proper planning, however, corporations are generally able to accumulate substantial earnings as working capital. See, e.g., Davenport, *supra* note 16. Other devices designed to minimize the benefits of deferral are the personal holding company provisions, see I.R.C. §§ 541-547 (West 2003); BITTKER & EUSTICE, *supra*, §§ 7.20-7.24, and the collapsible corporation rules, see I.R.C. § 341 (West 2003); BITTKER & EUSTICE, *supra*, §§ 10.60-10.66.

In a similar vein, earnings retained in a foreign corporation not subject to United States corporate income taxation and subject to relatively low tax rates abroad are effectively subject to

indefinite deferral of the single-level shareholder tax would move the existing tax regime much closer to a consumption based tax regime, in which taxation of capital income is deferred until consumed.¹⁰⁷ Notwithstanding the many serious arguments in favor of a consumption tax paradigm,¹⁰⁸ this incremental step in that direction is not necessarily advisable taken in isolation. In the absence of a broader consumption tax program, the benefits of such a partial move toward consumption taxation would need to be balanced carefully against the distortions it would generate. There are mechanisms available for advancing the consumption tax agenda without exacerbating the distortions of the classical tax regime.¹⁰⁹ Whatever benefits would accrue in terms of the consumption tax agenda, this Article addresses only the issues raised by the unintegrated classical tax regime compared to an integrated income tax regime. Moreover, in the absence of the political resolve to reconcile systematically tax policy to a consumption tax norm, this large-scale increase of inside shelter is unlikely to come to pass.

The second easily dismissed proposal is the full abolition of the shareholder-level tax. If taken literally, that is, the exemption from taxation of both dividends and gain from share disposition, it would be difficult to prevent such a program from largely repealing the tax on asset sales. Taxpayers could easily place assets into corporate solution and recognize their full economic value by the tax-free disposition of the holding corporation's shares. Even if the abolition were accompanied by an aggressive regime to police for uses of corporate form motivated primarily by avoidance of the capital gains tax, many asset dispositions would avoid tax entirely. In many cases, assets could be sold to fund consumption expenditures and not bear any tax burden, a result not contemplated by either an "accretionist income tax"¹¹⁰ or a consumption tax.

a lower tax burden than are similar earnings of corporations subject to the United States corporate income tax. See Avi-Yonah, *supra* note 16, at 1324-25. A number of provisions serve to reduce the efficacy of this form of deferral. See I.R.C. §§ 551-558 (West 2003) (foreign personal holding company rules), *Id.* §§ 951-964 (controlled foreign corporation rules); *Id.* § 1248 (disposition of stock in certain foreign corporations); *Id.* §§ 1291-1297 (passive foreign investment company rules). See also BITTKER & EUSTICE, *supra*, §§ 15.40-15.65 (discussing these provisions).

107. Shareholders could further defer the day of tax reckoning by funding consumption expenditures through borrowing against appreciated share values. Taxpayers already have the ability to leverage their way to liquidity, but, under the existing regime, to the extent that leverage is supported by corporate stock, it is supported by earnings that have already been subject to the corporate level tax regime. As such, eliminating the corporate level tax further expands shareholders' ability to defer taxation of appreciated value beyond the time of its consumption.

108. See *infra* notes 180-81 and accompanying text.

109. See *infra* notes 180-81 and accompanying text.

110. The term "accretionist income tax" refers to a regime with a tax base identical to the Haig-Simons definition of income, which is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between

As a practical matter, a simple program of abolishing the shareholder-level tax would be confined to exempting dividends from shareholder-level taxation. Even if implemented in this simple fashion, this step would effect only partial integration because it would not eliminate the double taxation of retained earnings, and distributed earnings would necessarily be taxed at the corporate tax rates rather than at the marginal rates of the shareholders to whom distributed. The taxation of dividends at capital gains rates under the 2003 Tax Act can be seen as a partial and temporary dividends exclusion regime.¹¹¹ That dividends exclusion is only partial integration does not necessarily counsel rejection of the dividend exclusion model of integration if no other model proves viable.¹¹² It is important, however, to recognize its limitations as a partial integration program.

Any number of such partial integration programs have been advanced. In addition to the full-partnership imputation paradigm¹¹³ and the dividends exclusion model¹¹⁴ previously noted, possible tax integration programs include:

- (i) An imputation-credit regime under which dividends are "grossed-up" to include a corresponding portion of taxes paid by the corporation, and shareholders are simultaneously permitted a refundable credit for the corporate taxes imputed to them;¹¹⁵
- (ii) A dividend deduction regime under which a corporation would be permitted a deduction for dividends to the extent traced to taxable earnings;¹¹⁶ and

the beginning and end of the period in question." HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938); see also Robert Murray Haig, *The Concept of Income-Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 7 (Robert Murray Haig ed., 1921) ("Income is the money value of the net accretion to one's economic power between two points of time.").

111. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64.

112. As the discussion below will illustrate, all of the likely practicable alternative forms of integration share the limitations of being partial integration regimes and of generating their own sets of secondary issues requiring resolution.

113. See *supra* notes 97-98 and accompanying text.

114. See *supra* notes 110-12 and accompanying text.

115. See TREASURY STUDY, *supra* note 12, at 93-106; ALI STUDY, *supra* note 12.

116. See ALI STUDY, *supra* note 12, at 52-54. In a slight variation, corporations would be permitted to deduct dividends on new equity investments. See AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT SUBCHAPTER C, REPORTER'S PROPOSALS ON INCOME TAX TREATMENT OF CORPORATE DISTRIBUTIONS* 356-99 (1982); AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY DRAFT* 97-101 (1989).

- (iii) A mark-to-market regime under which shareholders would be taxed on the annual change in the value of their shares as a substitute for the existing corporate tax.¹¹⁷

Each of these alternatives has merit and several characteristics in common. First, each is a form of partial integration rather than thorough integration. Second, each requires a significant reworking of the existing tax regime. Some of them replace old legal structures with new legal structures, while others add significant new legal structures to the existing regime.

Last, each program faces political complications because implementation is possible only by a comprehensive act of Congress. A plethora of potential reforms and adjustments to the Internal Revenue Code persistently face Congress. Legislative action comprehensive enough to effect corporate tax integration is likely only if its supporters can avoid its displacement by other items on the tax legislation agenda. That in turn requires a concentrated and organized constituency that will make its passage a priority.

Corporate shareholders have an obvious interest in advancing the integrationist agenda, but shareholders of publicly held corporations suffer in this context from the same collective action problems that pose the well-known variety of corporate governance issues arising in any Berle-Means corporation.¹¹⁸ Shareholders of closely held enterprises do not face the same collective action problems, and the result is clear. Closely held enterprise investors have received a more favorable result than tax integration; they are able, as a class, to elect between functional tax integration and inside shelter.¹¹⁹

Shareholders of publicly traded corporations would need a well-organized ally to lobby for comprehensive corporate tax integration. Corporate managers, as a class, are the most likely ally, but as Professors Arlen and Weiss have observed:

[S]hareholders and managers will often have divergent views on tax policy. . . . Shareholders invariably favor policies that increase the return to existing capital; they sometimes, but not always, support policies that stimulate investment. In contrast, managers are primarily concerned with stimulating new investment. They have little interest in increasing the return

117. See Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995); Anthony P. Polito, *Dual-Approach Tax Integration: Issues for Discussion*, 73 TAX NOTES 1213, 1217-19 (1996).

118. Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 363-65 (1995).

119. See *infra* notes 153-68 and accompanying text.

to existing capital, though they do not actively oppose measures that do this. Managers therefore attach a low priority to integration, which provides [what some regard as] a large windfall to existing capital, and only a small stimulus to new investment. Managers prefer to lobby for other tax measures, such as ACRS [(accelerated cost recovery system)] and ITCs [(investment tax credits)], that may be less advantageous to shareholders but are more cost-effective in stimulating investment.¹²⁰

Managers prefer tax legislative agendas that will simultaneously reduce the tax burden of capital and justify the continued retention of corporate earnings for new investment projects.

Most managers support integration but have not lobbied on behalf of it. . . .

. . . . Retained earnings are accompanied by less monitoring than other forms of finance, and managers consequently prefer them to other sources of capital. Shareholders, in turn, dislike retained earnings financing precisely because it insulates managers from scrutiny.¹²¹

Managerial acquiescence plays a large part in persistence of the double-tax regime.¹²² As Professor Banks observed, "it is not surprising that managers have not been very inclined to actively lobby for the passage of one of the many integration proposals that have arisen over the years."¹²³

120. Arlen & Weiss, *supra* note 118, at 336.

121. *Id.* at 348.

122. Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 534-35 (2001); John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445, 1446 (1990); James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 716 (1997); James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 1034-35 (1992); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 n.8 (2000); Lee A. Sheppard, *Dividend Integration: An Idea Whose Time Will Never Come*, 98 TAX NOTES 9, 9 (2003); Lee A. Sheppard, *Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 638-39 (1985); Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 173-174 (1997).

123. Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 261 (2002).

The Bush Administration assembled legislative majorities for two tax cut acts¹²⁴ that each reduce revenues by hundreds of billions of dollars, but the proposal for a nearly comprehensive integration proposal was eclipsed by other tax cutting priorities. Instead, the Bush Administration had to settle for partial relief from double taxation, and even that relief is scheduled to expire in 2008.¹²⁵ This suggests that any comprehensive permanent scheme of corporate tax integration is unlikely to survive the politics of the legislative process.

This is the first premise of the Laissez-Faire Approach. As a practical matter, the idealized integrationist ideal is unattainable because it is administratively not practicable. Any practical integration initiative will achieve less than the full integrationist ideal, requires the layering of significant additional legal and administrative complexity on the existing tax regime, and is unlikely to rally the political support necessary for its survival in a crowded arena of proposed tax legislation.

B. Leaky Double Taxation

The second major premise of the Laissez Faire Approach is the observation that, notwithstanding the unlikelihood that Congress will adopt comprehensive and permanent corporate tax integration, the excess tax burden generated by the classical tax regime is ample incentive for taxpayers to seek alternative means of escaping the excess burden of double taxation. Corporate tax revenues have decreased fairly steadily as a share of total federal revenues, from 40% in fiscal year 1940 to a range of 12% to less than 8% per fiscal year over the last decade.¹²⁶ Much of that decline may be traced to phenomena that serve, at the margin, to overcome or mitigate the excess tax burden.

Taxpayers have long had and used several important self-help tools to mitigate the burden of double taxation. Closely held corporations, to the extent that their shareholder-employees are taxed equivalently with respect to earnings distributed as dividends, as with respect to compensation,¹²⁷ can attempt to minimize the corporate tax burden by removing earnings from corporate

124. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

125. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64.

126. ECONOMIC REPORT OF THE PRESIDENT 415, Table B-80 (2002).

127. Clark, *supra* note 16, at 106 (recognizing that dividends are often treated as ordinary income); see also HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 155-57 (5th ed. 2002) (describing the nature of dividends and the imposition of the shareholder level tax on only distributed corporate profits).

solution as deductible compensation.¹²⁸ If a corporation's populations of employees and shareholders do not sufficiently overlap to make the compensation-bailout of earnings a viable tax strategy,¹²⁹ other mechanisms are available. A corporation can leverage itself: the greater its debt-to-equity ratio, the more it removes its revenues from the ambit of the corporate tax and reduces the double tax burden.¹³⁰ If double taxation cannot be avoided at the entity level, it can be mitigated at the shareholder level. A corporation may generally reduce the excess tax burden by retaining earnings¹³¹ or by attempting to "bail-out" earnings at capital gains rates.¹³²

Businesses have also sought to qualify for pass-through treatment as partnerships. Indeed, businesses have found it profitable to absorb fairly

128. I.R.C. § 162(a) (West 2003).

129. The separation of ownership and control in the Berle-Means corporation implies that inflating employees' compensation will reduce corporate tax but at the expense of diverting shareholder value. It may be that managerial compensation in such corporations is excessive, but that excess is not tax motivated. As such, the IRS does not police for the reasonableness of compensation. *Id.* § 162(a)(1), outside of the closely held corporation context. *See, e.g.,* Edward A. Zelinsky, Eberl's *Independent Investors*, and the *Incoherence of the Reasonable Compensation Rule*, 92 TAX NOTES 555, 559 (2001); Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123, 1124 (1993).

130. The real burden of an increased risk of bankruptcy is the real cost of increasing leverage. *See supra* notes 44-49 and accompanying text. Therefore, there are limits to the usefulness of this technique. Nevertheless, policy makers do treat as significant the likelihood that the tax advantage of debt financing has at various times produced significant inflation of debt capitalization levels. *See* Leonard L. Silverstein, *Impact of the Acquisition Indebtedness Provisions of the Tax Reform Act of 1969 on Corporate Mergers*, 44 ST. JOHN'S L. REV. 353, 355-56 (1970) (quoting Assistant Attorney General Richard W. McLauren to the effect that overly leveraged acquisitions raised a "serious concern over the severe human and economic dislocations which are resulting from the current tax-propelled merger mania"); *see also* BITTKER & EUSTICE, *supra* note 16, § 4.26[1]. A similar concern with excess debt led Congress to consider additional restrictions on corporate leverage in the late 1980s. *See* STAFF OF JOINT COMM. ON TAXATION, 101ST CONG., *FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES I* (Comm. Print 1989).

The desire to win debt classification also creates pressure on the distinction in tax law between debt and equity. The result has been the baroque and largely unworkable body of law governing that issue. *See, e.g.,* Polito, *Useful Fictions*, *supra* note 5, at 777-82; Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1058-94 (2000).

131. *See supra* notes 15-32 and accompanying text.

132. *See* Donald F. Brosnan, *Spin-Offs Before and After the Tax Reform Act*, 38 BUFF. L. REV. 157, 157-62 (1990); Clark, *supra* note 16, at 110-11, 119-30; Ronald E. Lowe, *Bailouts: Their Role in Corporate Planning*, 30 TAX. L. REV. 357 (1975); Hugh Rowland, Jr., *Section 306: Its History and Function as Bailout Preventer (Including Bailouts that May Never Occur)*, 39 TAX LAW. 121, 145, 151-52, 155 (1985); Daniel M. Schneider, *Internal Revenue Code § 355 Before and After the Tax Reform Act of 1986: A Study in the Regulation of Corporate Tax Bailouts*, 39 OKLA. L. REV. 567, 567-71 (1986).

substantial attorney and other costs in the quest to qualify marginally as partnerships eligible for pass-through treatment.¹³³ At the same time, state legislatures have found it in their economic interests to promote pass-through tax treatment for in-state businesses. Every state has done so through the adoption of a limited liability company act.¹³⁴ A series of IRS Revenue Rulings permitting the classification of limited liability companies as partnerships¹³⁵ made it possible for businesses to receive the benefits of limited liability without sacrificing the pass-through tax treatment of partnerships.

In the end, the Treasury ratified these actions by closely held businesses, and allies of those businesses in state legislatures allowed virtually costless tax integration for closely held businesses. Under the "check-the-box" classification regulations, any noncorporate business entity is eligible to elect treatment as a corporation or as a partnership for income tax purposes.¹³⁶ Because many state statutes authorizing LLCs and related entities permit the election of some, or all, of the four corporate characteristics¹³⁷—limited liability, free transferability of interests, centralized management, and continuity of existence—the combination of the check-the-box regulations and section 7704 effectively permits pass-through tax treatment for any noncorporate business whose equity interests are not publicly traded and for some that are publicly traded.¹³⁸

In a number of specialized cases, Congress has yielded to pleas for escape from double taxation. In one sense, the existence of the Subchapter K rules for partnerships¹³⁹ is a congressionally approved escape hatch from double taxation. Congress could have long ago sought to reduce the evisceration of the corporate tax base by imposing a uniform double tax on all businesses.¹⁴⁰ It has

133. See Hobbs, *supra* note 63, at 498-518.

134. See CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW*, ¶ 1.01[1] (1999).

135. See Rev. Rul. 88-76, 1988-2 C.B. 360; Rev. Rul. 93-5, 1993-1 C.B. 227; Rev. Rul. 93-6, 1993-1 C.B. 229; Rev. Rul. 93-30, 1993-1 C.B. 231; Rev. Rul. 93-38, 1993-1 C.B. 233; Rev. Rul. 93-49, 1993-2 C.B. 308; Rev. Rul. 93-50, 1993-2 C.B. 310; Rev. Rul. 93-53, 1993-2 C.B. 312; Rev. Rul. 93-81, 1993-2 C.B. 314; Rev. Rul. 94-5, 1994-1 C.B. 312; Rev. Rul. 94-6, 1994-1 C.B. 314; Rev. Rul. 94-30, 1994-1 C.B. 316; Rev. Rul. 94-51, 1994-2 C.B. 407; Rev. Rul. 94-79, 1994-2, C.B. 409; and Rev. Rul. 95-9, 1995-3 I.R.B. 17.

136. See Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

137. See BISHOP & KLEINBERGER, *supra* note 134, ¶ 1.01[4].

138. See *supra* notes 65-66 and accompanying text.

139. See I.R.C. §§ 701-777, 6221-6234 (West 2003).

140. See Mortimer M. Caplin, *Income Tax Pressures on the Form of Business Organization: Is it Time for a "Doing Business" Tax?*, 47 VA. L. REV. 249, 260-63 (1961); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1175 (1992).

not done so. On the contrary, it has created a number of additional mechanisms for businesses to receive pass-through treatment in avoidance of double taxation. It created the S corporation mechanism to grant pass-through treatment to many closely held corporations,¹⁴¹ and it has periodically expanded the availability of S corporation treatment.¹⁴² Likewise, Congress has effectively eliminated the double tax burden for a number of specialized investment vehicles.¹⁴³

As in so many areas of the tax law, the double tax regime is actually a hybrid system. Double taxation coexists with numerous mechanisms that allow the benefits of integration to selected taxpayers or to aggressive taxpayers. The coexistence of these conflicting paradigms is the source of ongoing tension between taxpayer and fisc that engenders much of the existing regime's legal and administrative complexity. As long as the double tax system remains in place, the IRS sees itself as compelled to police for dividends disguised as deductible compensation, interest, or as capital gains transactions.¹⁴⁴ If Congress imposes a penalty on ostensible attempts to escape shareholder level taxation through the unreasonable retention of earnings,¹⁴⁵ the IRS must scrutinize corporations that do retain those earnings. If Congress decides to deny pass-through treatment to most publicly traded businesses,¹⁴⁶ the IRS must police that definitional boundary of pass-through eligibility.¹⁴⁷ If Congress grants S corporation treatment only to corporations that satisfy a number of

141. I.R.C. §§ 1361-1379 (West 2003).

142. Robert E. Meale, *Eligibility, Election and Termination Under the Subchapter S Revision Act of 1982*, 11 FLA. ST. U. L. REV. 93, 97-111 (1983) (describing eligibility liberalizations in the 1982 revision of subchapter S); Lee A. Sheppard, *Virtual Affiliation for S Corporations*, 62 TAX NOTES 661, 661 (1994) ("Every few years Congress is importuned by accountants and other representatives of closely held business to 'reform' subchapter S, by which is meant 'make it even more generous.'"). As of this writing, the most recent systematic liberalization of subchapter S was enacted in 1996. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1301-1317, 110 Stat. 1755, 1777-87.

143. I.R.C. §§ 851-860 (West 2003) (alleviating double tax for regulated investment companies and real estate investment trusts); *Id.* §§ 860A-860G (alleviating double tax for real estate mortgage investment conduits); *Id.* §§ 860H-860L (alleviating double tax for financial asset securitization investment trusts). An affirmative program of comprehensive corporate tax integration would displace these specialized vehicles, but, as further described *infra*, the Laissez-Faire Approach of advancing the integrationist agenda within the framework of the existing legal regime counsels leaving these mechanisms in place, even as new integrationist steps are advanced.

144. *See, e.g.*, Clark *supra* note 16, at 106-17 (describing the dividend and corporate veil principles).

145. I.R.C. §§ 531-537 (West 2003) (imposing accumulated earnings tax).

146. *Id.* § 7704.

147. Elective classification under the "check-the-box" regulations, see Treas. Reg. §§ 301.7701-2, (as amended in 1999), 301.7701-3 (as amended in 2001), has largely eliminated the IRS's policing obligations with respect to partnership classification for closely held businesses.

detailed and complicated rules,¹⁴⁸ the IRS must police those rules. The same may be said of the eligibility criteria for various specialized pass-through regimes.¹⁴⁹

In each of these cases, taxpayers will press to escape the double tax system to the degree that the rewards are worth their efforts. The defenders of the fisc must divine the extent to which Congress is willing to allow that escape. This is no mean feat because Congress has clearly endorsed both thesis and antithesis: double taxation and the escape from double taxation.

C. *Laissez-Faire Conditions*

The interaction of these two premises is the genesis of the mandate for the Laissez-Faire Approach. Full fiscal transparency is not achievable. At the same time, some business enterprise earnings will always be subject to the excess tax burden of double taxation. Other business earnings will escape double taxation. It is impossible to realize fully the anti-ideal of double taxation, because slippage at the margins is unavoidable. The boundary is, and will remain, arbitrary, because it is defined by the extent to which taxpayers are able to take advantage of the leaks in the double tax anti-ideal. Yet the IRS bears significant burdens and the legal system grows in complexity while attempting to plug the leaks in the double tax regime.

The Laissez-Faire Approach proposes an alternative. If integrationism is the ideal, and if the realities of the political process, legal complexity, and administrative burden are inescapable enemies of its full effectuation, the tax law regime should nevertheless avoid operating at cross purposes. Complicated and administratively burdensome, the legal and enforcement mechanisms that serve to defend the double tax anti-ideal should be either marked for elimination or simply disregarded, but only to the extent that those regimes reinforce the double tax anti-ideal.¹⁵⁰ At the same time, given that

148. I.R.C. § 1361 (West 2003) (defining qualifications for S corporation treatment).

149. See *supra* note 143.

150. In principle, the tension could also be largely resolved by perfecting the double tax regime as the universal norm of business taxation. Such a regime would seek to impose the double tax regime as comprehensively as possible on all business enterprises, notwithstanding the problems of economic misallocations and equity that such a system would create. A comprehensive double tax system would have fewer boundaries to police and, therefore, would not generate a lot of the complexity and administrative burdens of the current system. It would also exacerbate the current system's double taxation flaws, of which policy-makers must be aware because they have allowed the progressive erosion of the corporate tax base. In addition, the incentives for taxpayers and local government to create escape paths from the corporate tax will remain. It is the existing system's dynamic interaction of taxpayer attack and fiscal defense that largely creates the complexity that grows over time. See Clark *supra* note 16, at 94-96.

comprehensive corporate tax integration is unlikely at best, and that the creation of new regimes will not fully achieve the integrationist agenda in any case, the Laissez-Faire Approach advances the integrationist agenda without the creation of any significant new legal paradigms or regimes. Instead, it pursues opportunities to advance the integrationist agenda by declining to defend the escape hatches in the existing double tax regime.

The prescription of the Laissez-Faire Approach is neither for an active program of integration nor is it for aimless drift. Rather, it is to take advantage of taxpayers' natural tendency to minimize tax burdens by setting conditions that encourage those tendencies to advance progress toward the integrationist ideal. A number of relatively simple changes in tax law doctrinal principles and enforcement regimes would facilitate this approach to corporate tax policy. They qualify for inclusion in the Laissez-Faire Approach based on the satisfaction of two conditions.

First, the Laissez-Faire Approach seeks to advance integrationism by self-help rather than by assuming the burden of an active integration program. As such, elements in the Laissez-Faire Approach are designed to avoid, to the greatest extent possible, the need to fashion new legal or enforcement regimes. Instead, the elements of the Laissez-Faire Approach are designed principally to eliminate or disregard existing legal and enforcement regimes. The regimes marked for removal or disregard are those that serve to defend the double tax anti-ideal.

Second, the Laissez-Faire Approach is not a program to facilitate avoidance of income taxation entirely. The integrationist ideal is for all income to be taxable at the level of the individual taxpayer, as if they conducted the businesses directly without the intervention of juridical business organizations. Accordingly, it avoids mechanisms that would allow income to escape the full burden of the individual income tax. In essence, the Laissez-Faire Approach facilitates corporate escape from double taxation so long as doing so preserves at least one level of taxation.

Various elements advanced as part of the Laissez-Faire Approach can be effected by (i) minor amendments to the Internal Revenue Code, (ii) by the promulgation of Treasury regulations or Internal Revenue Service administrative guidance, (iii) informal Internal Revenue Service enforcement practice, or (iv) judicial action. This Article presents and assesses the desirability of these proposed actions purely from the perspective of advancing an integrationist agenda. It intentionally sets aside the issue of authority for effecting its proposals without explicit legislation.

The check-the-box regulations¹⁵¹ serve as a good example of the issue intentionally bracketed for purposes of this discussion. From an integrationist perspective, the check-the-box regulations are a clear advance because they effectively allow pass-through treatment for any closely held business. The promulgation of those regulations raised a nontrivial issue of whether the Treasury had the authority to grant partnership tax classification to business entities that are functionally indistinguishable from closely held corporations, which would have been classified as “associations” taxable as corporations under prior interpretations of the Internal Revenue Code.¹⁵² This Article remains intentionally agnostic with respect to issues of this variety, acknowledging—but not addressing—the problem of authority in relation to other norms present in legal discourse.

IV. THE PROBLEM OF INSIDE SHELTER

A threshold consideration for the Laissez-Faire Approach is whether to reduce or eliminate the taxpayers’ affirmative ability to use the taxable corporation as a form of tax shelter. The disparity of tax rates imposed on corporations and those imposed on their individual taxpayers makes this possible. Consider a business enterprise with pretax earnings of E . Business profits earned through a pass-through entity are subject to the full individual level tax (p) as realized at the entity level, yielding after tax earnings of $E(1 - p)$. Those earned through a taxable corporation are subject to the corporate tax rate (c) as earned, and a second tax rate (k) when distributed or realized as gain on the sale of shares, yielding after-tax earnings $E(1 - c)(1 - k)$. Under what circumstances is the tax burden on pass-through entities higher than on taxable corporate entities? Equivalently, what conditions make the following statement true?

$$E(1 - p) < E(1 - c)(1 - k)$$

151. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

152. See STAFF OF JOINT COMM. ON TAXATION 101ST. CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 13-16 (Comm. Print 1997), reprinted in WILLIAM S. MCKEE ET AL., 1 FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.08 (Cum. Supp. 1997). See also Hugh M. Dougan et al., ‘Check-the-Box’—Looking Under the Lid, 75 TAX NOTES 1141, 1143-44 (1997) (discussing the validity of the new Treasury regulations); Victor E. Fleischer, Note, “If It Looks Like a Duck”: Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 COLUM. L. REV. 518, 532-38 (1996) (discussing special deference given to the Treasury).

If $c \geq p$, the inequality never holds. The corporate entity always bears at least as heavy a tax burden as a pass-through entity, even if the individual level tax rate on corporate earnings is reduced to zero. On the other hand, if $c < p$, the pass-through entity bears a heavier tax burden if k is sufficiently less than p .

As a historical matter, the maximum marginal income tax rate applicable to individuals has exceeded that applicable to corporations throughout most of the income tax's history.¹⁵³ In addition, $k < p$ is always true. First, because the shareholder-level tax can be deferred almost at will,¹⁵⁴ the effective tax rate on dividends is lower than the tax rate on pass-through entity earnings even if the nominal tax rate is identical. Second, the disparity is further increased to the extent the retained earnings reflected in share value are subject to preferential capital gains treatment,¹⁵⁵ or avoid shareholder-level income tax entirely by the step-up in basis at death.¹⁵⁶ Provided some corporations are subject to a marginal tax rate that is lower than that applicable to their shareholders, there will exist the possibility of creating an inside shelter by retaining earnings to avoid the full impact of the progressive individual rate structure.

It is true that under the terms of the 2001 Tax Act and the 2003 Tax Act, the maximum individual and corporate marginal income rates will be an identical 35%.¹⁵⁷ Both the corporate and individual rate structures, however, bear some degree of progressivity. Even if the new individual tax rates remain fully effective,¹⁵⁸ $c < p$ will be true for at least some corporations. A significant

153. See *supra* note 22 and accompanying text.

154. I.R.C. § 61(a)(3), (7) (West 2003).

155. *Id.* § 1(h). The 2003 Tax Act makes the capital gains rate applicable temporarily to dividend distributions. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64.

156. I.R.C. § 1014 (West 2003). Although the 2001 Tax Act revokes the effect of § 1014 for property inherited after 2009, Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 541, 115 Stat. 38, 76, it allows a step-up in basis subject to a maximum amount of basis increase per decedent. For domestic taxpayers the limits are quite high, \$1.3 million per decedent, with an additional \$3 million for transfers to surviving spouses, and both figures are to be adjusted for inflation after 2010. *Id.* § 542, 115 Stat. at 76 (codified as I.R.C. § 1022). As a practical matter, therefore, the step-up in basis will remain fully in effect for the vast majority of taxpayers, and will allow the step-up for a significant fraction of the assets of the balance of taxpayers.

157. Under the terms of the 2001 Tax Act, the maximum stated personal tax rate was scheduled to be reduced to 35% by 2006. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41. The 2001 Tax Act has also scheduled the repeal of deduction phase-outs that will be fully effective in 2010. *Id.* §§ 102-103, 115 Stat. at 44-45. The 2003 Tax Act accelerated the tax rate reduction. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 105, 117 Stat. 752, 755.

158. As of this writing, the provisions of the 2001 Tax Act remain subject to a sunset provision that takes effect at the end of 2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150; Jobs and Growth Tax Relief

minority of taxable corporations report annual income of less than \$355,000,¹⁵⁹ the corporate income level at which the Code fully phases out the benefit of the corporate tax rates lower than 34%.¹⁶⁰

Even for corporations able to take advantage of the lower rates, it is true that $c \geq p$ if shareholders are in the lower tax brackets. The inside tax shelter of the corporation benefits only high income individuals, and, indeed, a high percentage of smaller corporations' shareholding is concentrated among higher tax rate individuals.¹⁶¹ Thus, a significant portion of corporations ostensibly subject to a double tax serve to shelter income, because of the disparity of their 15% or 25% corporate income tax rates and their shareholders' significantly higher individual tax rates. The general reduction of individual income tax rates¹⁶² will reduce the value of this inside shelter, but it will not eliminate it entirely.

Moreover, even corporations with incomes above \$355,000 are able to provide some degree of shelter.¹⁶³ The corporate income tax is functionally a flat tax at the rate of 34% for corporations with taxable income between \$355,000 and \$10,000,000.¹⁶⁴ The existence of higher individual tax rates provides for the possibility of deferral. Even with the reduction of the maximum individual tax rate to 35%, there remains the possibility of inside

Reconciliation Act of 2003, Pub. L. No. 108-27, § 107, 117 Stat. 752, 755-56. The question of whether to repeal the sunset provision remains an open political question, and bills to effect such a repeal have been introduced in both Houses of Congress. H.R. 407, 108th Cong. § 1 (2003); Contract With Investors, S. 96, 108th Cong. § 2 (2003).

159. According to the Joint Committee on Taxation's 1993 figures, 37% of taxable corporations report taxable income of less than \$355,000 per year. STAFF OF JOINT COMM. ON TAXATION, 104th Cong., IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX 5, at n.8 (Comm. Print 1996). The Joint Committee also reports that 61% of all taxable corporations report no taxable income. *Id.* To the extent that their revenue is fully accounted for as payments that are taxable income to their recipients (even if paid as deductible salaries), this statistic is not troublesome to a goal of a regime producing neither double taxation nor under-taxation of business income. Corporate under-taxation is only an issue to the extent that the taxable corporation is used to shelter income from higher personal tax rates.

160. I.R.C. § 11(a)-(b) (West 2003).

161. John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 908-09 (2000).

162. The 2001 Tax Act, in addition to creating a top individual tax rate of 35%, reduces the 36% bracket to 33%, the 31% bracket to 28%, and the 28% bracket to 25%. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 42. In addition, it reduced the 15% bracket to 10%, effective 2001. *Id.* § 101, 115 Stat. 38, 41. *See also* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 101-107, 117 Stat. 752, 753-56.

163. *See* Lee, *supra*, note 161, at 921-22.

164. I.R.C. § 11(a)-(b)(1)(D) (West 2003). A marginal rate of 35% applies above that amount, and the benefit of the 34% rate is fully phased-out for corporations with taxable incomes greater than \$18,333,333. *Id.*

shelter using 34% bracket corporations. For sufficiently long deferral periods converting the nominal capital gains tax rate into a sufficiently low effective capital gains tax rate, a 34% tax rate corporation may provide inside shelter to shareholders in the 35% tax bracket.¹⁶⁵ Inside shelter is certainly available for such a one-point spread in rates if the stock of the corporation retaining its earnings changes hands only via the death of its holder (most easily arranged for controlling shareholders of closely held corporations without a financial need to pay regular dividends), because the stock is subject to an effective capital gains rate of 0% as a result of the step-up in basis.¹⁶⁶ In the 34% case, as in the case of lower tax bracket corporations, it is the disparity of rates that converts the corporation into an effective shelter for retained earnings.¹⁶⁷

Nevertheless, the value of inside shelter is proportionally greatest to corporations that are able to report taxable income of less than \$355,000. Widely held corporations are unlikely to fall below this ceiling on a regular basis. As such, inside shelter is most likely valuable in the case of closely held businesses.¹⁶⁸

165. Inside shelter is available if $(1-p) < (1-c)(1-k)$, where p is individual income tax rate, c is the corporate tax rate, and k is the effective capital gains tax rate. Given $p = .35$ and $c = .34$, $k \leq .015$ achieves effective inside shelter. The nominal capital gains tax rate can be converted into an effective capital gains rate if the after-tax earnings, with respect to the investment of the deferred tax, are equal to the difference between the nominal capital gains tax and the projected effective capital gains tax, according to the following equation:

$$E(g - k) = gE(e^{rT} - 1)(1-g)$$

where E is an amount of after-corporate-tax retained earnings, r is the after-corporate-tax rate of return with respect to those earnings, T is the period in years from the time the earnings accrue until the taxpayer sells corporate stock at capital gains rates, and g is the nominal capital gains rate. Given a maximum capital gains tax rate of .20, *Id.* § 1(h), and $k = .015$, one can resolve for T in terms of r as follows:

$$T = 0.768 \div r.$$

Based on this equation, minimum deferral periods to achieve effective inside shelter are available for various after-corporate-tax rates of return: for 2%—38.4 years, for 3%—25.6 years, for 5%—15.4 years, for 10%—7.7 years, and for 15%—5.1 years (subject to some rounding error). For a maximum capital gains tax rate of 15%, the same resolution is as follows:

$$T = 0.722 \div r.$$

This produces the following minimum deferral periods: for 2%—36.1 years, for 3%—24.1 years, for 5%—14.4 years, for 10%—7.2 years, and for 15%—4.8 years (subject again to some rounding error).

166. See *supra* note 156 and accompanying text.

167. See Lee, *supra* note 161, at 903-21. Another sense in which taxable corporations have served as tax shelters has been their ability to deduct the cost of shareholder-employee insurance premiums while treating them as tax-exempt fringe benefits to the shareholder-employees. Those deductions have been limited with respect to self-employed individuals, partners, and 2% shareholders in S corporations, but that disadvantage has been phased-out. I.R.C. § 162(l) (West 2003).

168. See Lee, *supra* note 161, at 903-21.

A. *The Case For Elimination*

With the advent of the check-the-box regulations,¹⁶⁹ elective tax integration via pass-through treatment is available for all closely held enterprises, and even some publicly traded enterprises.¹⁷⁰ So long as the dual tax rate structure exists, a system that allows enterprises to elect between separate corporate taxation and the integration of full pass-through treatment will find some enterprises electing the former for its benefits as a tax shelter. The existence of that form of shelter has potential implications for both distributive equity and allocative efficiency, although the former is likely to be the more significant issue. In addition, there are other considerations, all of them tied up in some measure with the politics of advancing the Laissez-Faire Approach, that militate in favor of eliminating inside shelter.

To the extent that the schedule of individual income tax rates reflects an implicit normative judgment regarding the best distribution of the tax burden, the inside shelter—like any other shelter that is not universally available—potentially undermines the validity of that implicit, normative judgement. From the perspective of vertical equity, the normative acceptability of the rate schedule is predicated on some set of assumptions about how that rate schedule affects the progressivity of the imposition of the tax burden. The existence of the inside shelter implies that the actual distribution of the tax burden is less progressive than the nominal tax brackets indicate. Because the inside shelter benefits some but not all taxpayers in any given income tax rate bracket, it is not readily susceptible to assimilation into the process of setting those brackets. As such, a valid set of tax distribution assumptions cannot be created by resetting the nominal tax brackets to account for the inside shelter.

If horizontal equity is considered a significant concern,¹⁷¹ it also makes the inside shelter problematic. Inside shelter is only selectively available, chiefly to those who participate in closely held enterprises. It is not available to many service-oriented businesses, because the lower corporate brackets do not apply

169. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

170. The check-the-box regulations allow an LLC or other noncorporate legal form to elect partnership pass-through treatment even if it functionally possesses all of the legal characteristics of a corporation. *Id.* On the other hand, most, but not all, publicly traded partnerships are treated as taxable corporations. I.R.C. § 7704. *See, e.g.,* Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 437 (1996).

171. *See supra* notes 76–82 and accompanying text. As noted in connection with the discussion of the double tax burden, the conclusory nature of the horizontal equity judgement makes it inherently problematic.

to personal service corporations.¹⁷² If this selective availability is not a valid predicate of disparate treatment for those who are otherwise in identical situations, then the inside shelter violates the principal of horizontal equity.¹⁷³ The entire discussion of distributive equity is further complicated to the extent that the uncertainty about incidence of the corporate tax¹⁷⁴ shifts an indeterminate portion of the inside shelter benefit away from equity investors.

Inside shelter may also create issues of allocative efficiency. By definition, inside shelter functions by the retention of earnings; therefore, it creates a bias that may impede the optimal removal of free cash flow¹⁷⁵ from corporate solution. On the other hand, in the context of closely held enterprises, in which the inside shelter is most valuable, the failure to distribute earnings may not generate the same adverse value effects as it does in the publicly traded Berle-Means corporation context, and earnings retention seems unlikely to prevent maximization of return for reinvestment of a closely held corporation's earnings. It is possible that the bias in favor of corporate tax classification may create needless administrative costs, but given the administrative complexity of most forms of pass-through taxation, these do not seem likely to be great at the margin. For enterprises organized before the advent of the check-the-box regulations,¹⁷⁶ inside shelter created a bias in favor of corporate form over other forms. Since then, however, the check-the-box regulations allow access to inside shelter without respect to choice of legal form of enterprise.¹⁷⁷

Another set of points urging elimination is essentially a negative one. The alleviation of the excess tax burden on corporate enterprise would result in a revenue loss to the fisc. Reduction of inside shelter would recoup some measure of that revenue loss. This recoupment has both a substantive policy effect and political effect. From a policy perspective, it permits the pursuit of

172. I.R.C. § 11(b)(2) (West 2003). A personal service corporation is "a corporation the principal activity of which is the performance of personal services" that "are substantially performed by employee-owners." *Id.* §§ 269A(b), 441(i)(2). Activities that involve "the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting" are treated as personal service activities. Treas. Reg. § 1.441-3(d)(1) (1987).

173. *But see supra* notes 83-91 and accompanying text (discussing the necessarily conclusory nature of this analysis).

174. *See supra* notes 92-93 and accompanying text.

175. *See supra* notes 35-37 and accompanying text.

176. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

177. To the extent that pass-through treatment is unavailable to publicly traded enterprises, I.R.C. § 7704(a) (West 2003), the inside shelter question cannot affect choice of entity. The existence of the check-the-box regulations, Treas. Reg. § 301.7701-3(c) (as amended in 2001), effectively allows closely held enterprises, and a limited class of publicly traded enterprises, I.R.C. § 7704(c), (g) (West 2003), to pursue inside shelter without effect upon the selection of an entity's operating characteristics.

the Laissez-Faire Approach without as great a requirement to increase the tax burden elsewhere in the system or to cut funding for programs. Of course, a conclusive judgment on this point depends upon knowing where the tax burden would be shifted and which programs would be cut.

A purely political aspect arises because some of the proposals of the Laissez-Faire Approach will require congressional approval. The attendant political process in which revenue estimates are used to justify tax legislation¹⁷⁸ would undoubtedly be eased if the revenue costs of the Laissez-Faire Approach were at least partly offset by the revenue gains of eliminating the inside shelter benefit. In a more general manner as well, the political picture for the Laissez-Faire Approach would be simplified if it incorporates reduction of inside shelter benefits. Notwithstanding the clear superiority of the integration goal, the cosmetics of legislating tax benefits to corporations might be problematic. Simultaneous congressional action on inside shelter would ease those cosmetics, because Congress could be portrayed as actually raising corporate tax rates, rather than as eliminating corporate taxation. The end of inside shelter would also serve as a defense against the inevitable, but untestable, argument that tax integration serves solely to reduce progressivity.¹⁷⁹

B. The Case Against Elimination

At the same time, there are points to be made against eliminating the benefit of inside shelter. A potential objection is that the so-called distortions of inside shelter serve to mitigate the distortions otherwise created by the existing income tax system. This is especially true in comparison to a regime that imposes a lighter burden on capital income, such as a consumption tax regime. Many serious minds have advanced thoughtful arguments, on both distributive equity and allocative efficiency grounds, that serve to justify advancing toward a consumption-tax paradigm.¹⁸⁰ Further supporting this view

178. For discussions of the revenue estimation process and its effect on tax policy, see Graetz, *supra* note 93, at 668-77; Alan J. Auerbach, *Public Finance in Theory and Practice*, 46 NAT'L TAX J. 519 (1993); Boris I. Bittker, *The Erwin N. Griswold Lecture*, 11 AM. J. TAX POL'Y 213 (1994); Emil M. Sunley & Randall D. Weiss, *The Revenue Estimating Process*, 10 AM. J. TAX POL'Y 261 (1992).

179. In addition, at the margin, the affirmative case for the Laissez-Faire Approach is strengthened by the elimination of inside shelter. That is, some elements of the Laissez-Faire Approach are susceptible of possible abuse in the presence of inside shelter opportunities, and are thereby strengthened by its elimination. While those instances do not appear to be of overwhelming significance, they are noted as they arise.

180. See, e.g., David F. Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 75 (Joseph A. Pechman ed., 1980); IRVING FISHER & HERBERT FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942); HARRY GRUBERT & T. SCOTT

are the many economic studies that conclude that an optimal tax system would not include a tax on capital.¹⁸¹

In terms of distributive equity, consumption tax proponents might see inside shelter as a form of self-help correction to a tax system that excessively burdens savers relative to consumers. From an allocative perspective, to the extent that the income tax creates a bias against saving and capital formation, the inside shelter serves to mitigate that bias, and the allocative benefits created thereby might well be greater than the allocative distortions created. In the context of a broader examination of the extent to which the so-called "income tax" regime does or should incorporate elements of a consumption tax, these points might be sufficient to justify the preservation of inside shelter. In the absence of such a broader program, however, the benefits of inside shelter need to be balanced carefully against the distortions it engenders.

NEWLON, TAXING CONSUMPTION IN A GLOBAL ECONOMY (1997); THOMAS HOBBS, LEVIATHAN ch. 30 (1651) (Richard Tuck ed., Cambridge Univ. Press 1991); INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (1978); Alfred Marshall, *The Equitable Distribution of Taxation* (1917), in MEMORIALS OF ALFRED MARSHALL 347, 350-51 (A.C. Pigou ed., 1925); JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY bk. V, ch. I, § 4 (Laughlin ed., 1884); LAURENCE S. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX (1997); William D. Andrews, *A Consumption-Type Tax or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Charles E. McLure, Jr., *The Simplicity of a Flat Tax: Is It Unique?*, 14 AM. J. TAX POL'Y 283 (1997).

181. See Peter Diamond, *Taxation and Public Production in a Growth Setting*, in MODELS OF ECONOMIC GROWTH 215-35 (James A. Mirrlees & N.H. Stern eds., 1973); Anthony B. Atkinson & Agnar Sandmo, *Welfare Implications of the Taxation of Savings*, 90 ECON. J. 529 (1980); Nicholas Bull, *When All the Optimal Dynamic Taxes Are Zero*, FEDERAL RESERVE BOARD WORKING PAPER SERIES #137; Christophe Chamley, *Efficient Taxation in a Stylized Model of Intertemporal General Equilibrium*, 26 INT'L. ECON. REV. 451 (1985); Christopher Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 ECONOMETRICA 607 (1986); V.V. Chari, et al., *Optimal Fiscal Policy in a Business Cycle Model*, 102 J. POL. ECON. 617 (1994); Martin Feldstein, *The Rate of Return Taxation, and Personal Savings*, 88 ECON. J. 482 (1978); Larry E. Jones, et al., *On the Optimal Taxation of Capital Income*, 73 J. ECON. THEORY 93 (1997); Larry E. Jones, et al., *Optimal Taxation in Models of Endogenous Growth*, 101 J. POL. ECON. 485 (1993); Kenneth L. Judd, *Optimal Taxation and Spending in General Competitive Growth Models*, 71 J. PUB. ECON. 1 (1999); Kenneth L. Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 J. PUB. ECON. 59 (1985); Kenneth L. Judd, *The Impact of Tax Reform in Modern Dynamic Economies*, in TRANSITION COSTS OF FUNDAMENTAL TAX REFORM 5-53 (K.A. Hassett & R.G. Hubbard eds., 2001); Robert E. Lucas, Jr., *Supply-Side Economics: An Analytical Review*, 42 OXFORD ECON. PAPERS 293 (1990).

C. *A Laissez-Faire Consistent Elimination Program*

It is certainly possible to redress inside shelter in a manner consistent with the methodology of the Laissez-Faire Approach. That task is easily accomplished without creating any new legal regimes or significantly reworking any of the existing regimes. The repeal of the lower corporate tax rate brackets and converting the corporate tax into a flat tax at the same rate as the highest rate individual tax bracket would effectively eliminate the inside shelter benefit.¹⁸²

Recent legislation has already begun to move the tax regime in this direction by reducing the maximum individual tax bracket to the maximum corporate bracket and generally reducing individual income tax rates.¹⁸³ While inside shelter could equally be advanced by raising the corporate tax rate to meet the preexisting individual tax rates, the integrationist agenda does not address the question of optimal tax rates as such. The Laissez-Faire Approach ought to remain agnostic as to what the maximum individual rate should be, and therefore, this Article brackets that issue as beyond its scope.

In isolation, these steps would face the objection that they increase the scope of the excess tax burden of double taxation, but they do not exist in isolation. Closely held enterprises and even some publicly traded enterprises are able to elect pass-through treatment¹⁸⁴ and eliminate the excess tax burden.¹⁸⁵

182. Taxable corporations have also served as tax shelters by deducting the cost of shareholder-employee insurance premiums while treating them as tax-exempt fringe benefits to the shareholder-employees. Those deductions have been limited with respect to self-employed individuals, partners, and 2 percent shareholders in S corporations, but that disadvantage has been phased-out. I.R.C. § 162(l) (West 2003).

183. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 101-107, 117 Stat. 752, 753-56.

184. See Treas. Reg. § 301.7701-3 (as amended in 2001); I.R.C. § 7704 (West 2003). A related question revolves around how to treat the conversion of existing taxable corporations into partnerships. Under existing law the conversion is a taxable liquidation. See *Id.* §§ 331, 336. On the one hand, if corporations have been used for inside shelter, an equity analysis may justify some toll for the benefit of converting to full pass-through treatment. On the other hand, for some corporations there will be a close question of whether the taxation of the deemed liquidation at both corporate and shareholder levels of previously unrecognized gain would be greater than the burden of losing the benefit of reduced tax brackets. As such, some closely held businesses may remain in the corporate tax regime notwithstanding the elimination of the inside shelter benefit, despite the allocative suboptimality of remaining subject to the excess tax burden. The empirical resolution of that question is beyond the scope of this Article.

185. For closely held enterprises, the elimination of inside shelter could also be accomplished by mandating some form of pass-through tax treatment. Presumably that pass-through treatment would be modeled on subchapter S or on subchapter K's treatment of partnerships. On the one hand, pass-through treatment premised on subchapter S would require significant

For other enterprises, the accentuation of the excess tax burden is illusory because the essence of the Laissez-Faire Approach is to ensure the accessibility of simple means of escaping that excess burden. Nevertheless, the arguments against elimination of inside shelter serve as a reminder that the issue of inside shelter may not be as pressing on its own merits as is that of double taxation. In addition, a conclusion about remedying double taxation need not necessarily imply a similar conclusion about remedying inside shelter.

V. CORPORATE-LEVEL BOUNDARY POLICING ADJUSTMENTS

Significant mitigation of the excess burden of the double tax regime can be achieved by the manner in which the corporate tax base is policed. The extent to which stakeholders' participation in the corporate earnings stream is deductible largely defines the extent of the double tax burden. A policy of permissive deductibility at the corporate level for amounts taxable at the stakeholder level contracts the scope of the double tax regime. Even a regime that taxes dividends at a lower tax rate than other income of individual taxpayers¹⁸⁶ imposes a double tax on the return to corporate equity, but not on corporate revenue streams deductible at the corporate level.

This Article focuses on two such deductibility issues. First, the extent to which employee compensation is considered reasonable, and therefore deductible, primarily affects closely held corporations. Second, the extent to which capital stakes are characterized as debt affects deductibility as interest.

reworking of the existing subchapter S regime. Examples of necessary changes would be regimes to allocate profit among multiple classes of stock and through multiple tiers of corporations, and to settle the related but independent question of the timing and method for allocating loss among multiple classes of stock and through multiple tiers of corporations. In addition, it would be necessary to expand the catalog of shareholders permissible under the existing S corporation regime, which is too restrictive to make it universal to all closely held corporations. *See, e.g.,* Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 314-23 (1995) (showing the feasibility of increasing the number of shareholders permitted under the S corporation rules). On the other hand, mandatory pass-through treatment via the subchapter K model would impose administrative and compliance burdens greater than those of subchapter C, as might also be the case under an expanded subchapter S model. Given that either of these solutions imposes complications not associated with tax bracket equalization, and that mandatory pass-through treatment would not affect inside shelter among publicly traded corporations, mandating pass-through treatment is not as consonant with the Laissez-Faire Approach as is equalizing the corporate and individual rates and allowing closely held enterprises to elect whether to avoid double taxation via pass-through treatment.

186. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 760-64.

Given that closely held businesses have access to pass-through taxation, it is of primary interest to publicly traded corporations.

A. *Minimizing Policing of Compensation's Reasonableness*

Under existing law, employee compensation is deductible only to the extent that it is reasonable. The IRS expends significant effort¹⁸⁷ seeking to limit corporate deductions to "a reasonable allowance for salaries or other compensation for personal services actually rendered,"¹⁸⁸ perhaps to little useful effect, given that taxpayers prevail in most of the litigated cases.¹⁸⁹ In these cases, the IRS seeks primarily to recharacterize "unreasonable" compensation paid to shareholder-employees as dividend distributions.¹⁹⁰ Once recharacterized in that manner, the payments generally remain taxable income to the recipient, but are not deductible by the paying corporation.

187. See, for example, Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 372 n.4 (1999) stating:

The reasonable compensation issue ranks among the most frequently litigated of all tax questions. General Accounting Office, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTIONS, GAO/GGD-95- 232 (Sept. 26, 1995) (hereinafter GAO Report). The General Accounting Office sampled Tax Court petitions filed in 1993 involving Code §162, having previously identified that section as the most commonly cited in tax controversies. *See id.* at 1. Within the sample, the reasonable compensation issue alone accounted for half of the dollar value of the taxes in dispute. *See id.* at 2. The issue was also the third most frequently disputed issue in the sample, ranking behind inadequate documentation and just behind the status of an activity as a "trade or business." *See id.* at 12. *See also* Richard K. Grigsby & David A. Reed, *How to Establish that Full Compensation Paid to a Shareholder-Employee is Deductible*, 24 TAX'N ACCT. 210 (1980) (The reasonable compensation issue "for many years has been one of the more frequently contested issues raised by Internal Revenue Service agents."). For compendia of hundreds of reasonable compensation cases, see generally Jacob Mertens, Jr., MERTENS LAW OF FED. INCOME TAXATION §25E:01-10.50 (1996); Gerald A. Kafka, REASONABLE COMPENSATION, 390 TAX MGMT. PORTFOLIO (BNA) (2d ed. 1993); Arthur J. Dixon, *Planning Reasonable Compensation*, 19 N.Y.U. ANN. INST. FED. TAX'N 181 (1961); Max E. Meyer, *Reasonableness of Compensation - A Tabular Review*, 26 N.Y.U. ANN. INST. FED. TAX'N 1121 (1968); Crawford S. Halsey & Maurice E. Peloubet, FEDERAL TAXATION AND UNREASONABLE COMPENSATION (1964). *Id.*

188. I.R.C. § 162(a)(1) (West 2003).

189. See, e.g., Hamill, *supra* note 170, at 415-18 (recognizing the IRS is unsuccessful in prevailing over taxpayers more than 50 percent of the time); Lee, *supra* note 161, at 918-19.

190. Treas. Reg. § 1.162-8 (1958).

The reasonableness inquiry requires an examination of the shareholder-employee's purported compensation against what likely would have been the compensation if negotiated at arm's length in the absence of the shareholding relationship. That inquiry is necessarily a fact specific one.¹⁹¹ Given the normal reluctance of judges to second-guess business judgements,¹⁹² the reasonable compensation doctrine leaves shareholder-employees much flexibility for maximizing the deductible amount of compensation. As a practical matter, it seems likely that many taxable corporations are able to eliminate successfully their corporate income tax entirely by passing earnings to shareholders as deductible salaries.¹⁹³ Others achieve further tax minimization by reducing corporate earnings only enough to take advantage of the inside shelter of the lower corporate tax brackets.¹⁹⁴

From an integrationist perspective, however, the reasonable compensation limitation on deductibility is largely a solution in search of a problem. The issue of reasonable compensation is effectively confined to closely held corporations, whose shareholder-employees have little concern for equity markets' reactions to dividend and compensation policies. These corporations are in a position to eliminate or minimize dividend distributions in favor of exaggerated compensation figures.¹⁹⁵

As Professor Zelinsky has wisely observed, the very existence of the reasonable compensation doctrine is anomalous under the existing regime, in which policy makers have decided in favor of pass-through treatment as the preferred tax treatment for closely held enterprises.¹⁹⁶ So long as the shareholder-employee is fully taxable with respect to the salary, allowing the deduction at the corporate level is no worse than pass-through treatment. From

191. Case law presents a number of slightly different formulations of the test of reasonable compensation. *See, e.g.,* *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 100-01 (2d Cir. 1998) (applying the "independent investor test" to all five factors found in *Elliotts*); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 n. 21 (5th Cir. 1987) (adding to those factors found in *Mayson* and *Elliotts*, while noting that the factors found in both *Mayson* and *Elliotts* are essentially the same); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245 (9th Cir. 1983) (applying the "independent investor test" as one of the factors used to judge the reasonableness of compensation, as well as reducing the number of factors found in *Mayson* from nine to five); *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949) (setting forth the initial nine factors used in some manner by the majority of federal courts).

192. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999) ("[J]udges are not competent to decide what business executives are worth.").

193. Sixty-one percent of all taxable corporations report no taxable income. STAFF OF THE JOINT COMM. ON TAXATION, 104th Cong., IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX, 5 n.8 (Comm. Print 1996).

194. *See supra* notes 153-68 and accompanying text.

195. *See Zelinsky, The Tax Policy Case, supra* note 129, at 1124.

196. Zelinsky, *Eberl's, supra* note 129, at 559.

an integrationist perspective, therefore, current enforcement practice is to that extent pure waste. A principle of consistency should be sufficient to resolve the compensation issue. So long as the recipient is fully taxable with respect to the compensation, the allowance of a deduction to the corporation is unproblematic.¹⁹⁷

As a matter of administration it is possible to impose upon the deducting corporation an obligation to document and report that the recipient is fully taxable with respect to the compensation. The IRS would need to be able to cross-reference recipients' returns to ensure that the compensation is being reported, but the withholding tax¹⁹⁸ and the W-4 regime is already in place for this purpose. In any case in which consistency is assured, there remains no justification to limit the corporate deduction to a "reasonable allowance for salaries or other compensation."¹⁹⁹

As a set of affirmative legislative proposals, the Laissez-Faire Approach calls for congressional adoption of a statutory definition of reasonableness in this context that makes all compensation reasonable if it is taxable to the recipient. In the alternative, the same result is achieved by acquiescence in administrative practice. The Laissez-Faire Approach recommends acquiescence in administrative action to effect the same definitional modification to the concept of a "reasonable allowance for salaries or other compensation."²⁰⁰ At an even greater level of passivity, it recommends lack of concern for and acquiescence in an enforcement practice of benign neglect that does not question the reasonableness of compensation to the extent that the recipient treats the compensation as taxable income.

To the extent that the benefit of inside shelter is eliminated, there is little reason for closely held enterprises to elect to be treated as taxable corporations rather than as pass-through entities. In those circumstances, the issue of reasonable compensation is largely academic because the same single level of

197. The only issue addressed here is reasonableness for purposes of the corporate deduction. A policy of not challenging reasonableness for purposes of deductibility need not preclude a challenge for other purposes. For example, in the S corporation context, the IRS may challenge shareholder-employee compensation as set unreasonably low in order to evade the social security taxes. See, e.g., Michael P. Watters & Daryl Burckel, *Establishing Reasonableness of Compensation Difficult in IRS Attacks*, 8 AKRON TAX J. 147 (1991) (noting legislation that reduces income taxes while social security taxes continue to increase).

198. I.R.C. §§ 3401-3406 (West 2003).

199. *Id.* § 162(a)(1).

200. *Id.* In theory this might be accomplished either by means of a regulation defining "reasonableness" in the manner suggested, or an IRS revenue ruling interpreting the term in that manner, or an IRS revenue procedure propounding administrative practice based on that interpretation of the term. This Article can remain agnostic on the validity of any such action. See *supra* notes 151-52 and accompanying text.

tax applies to both compensation and earnings.²⁰¹ Under the Laissez-Faire Approach, therefore, the issue may die of its own accord.

B. Police Debt Classification as a Matter of Form Only

A double tax regime identifies the corporate taxpayer with its equity capital chiefly by allowing a deduction for interest but not dividends.²⁰² In such a regime, the definitional distinction between a debt security and an equity security plays a central role in constructing the portions of the taxable corporation's revenue stream subject to double tax's excess tax burden, and expanding the scope of debt capital characterization at the margin removes earnings from the ambit of the corporate income tax.²⁰³ Even a regime that taxes dividends at the capital gains tax rate does not eliminate that disparity.²⁰⁴ Such a double tax regime necessarily devotes significant resources to defining and defending the distinction between a debt security and an equity security.

From an integrationist perspective, however, this effort is largely counterproductive. The removal of income from the corporate tax base is not only justified, it is the desired goal, so long as it is conditioned on the simultaneous inclusion in the security holder's gross income.²⁰⁵ In so far as debt classification determines the corporate-level deduction for interest amounts and the taxation of security holders with respect to the yield they enjoy on their investment, the prescription of the Laissez-Faire Approach is to accede largely to the debt classification of securities that are sufficiently in debt form to allow the administration of the existing tax regime for corporate debt. The integrationist agenda does, however, impose a pair of significant conditions.

First, the use of debt characterization to shift taxable income from the corporate tax base to the individual tax base requires a principle of consistent characterization. The issuer and the holder of the instrument must be bound to

201. *But see supra* note 197 and accompanying text (regarding the issue of compensation understated for purposes of the social security taxes).

202. *See* Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1603-10 (1974) (presenting a case for equating the corporation with both equity and debt capital for tax purposes by repealing the deduction for corporate interest obligations).

203. *See, e.g.,* Polito, *Useful Fictions*, *supra* note 5, at 770-74.

204. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 760-64.

205. There is a different, but ultimately related, issue of reclassifying rental payments under a lease as loan payments consisting of principal and interest. Given that the former are fully deductible, I.R.C. § 162(a)(3) (West 2003), but the latter are deductible only to the extent of interest, *Id.* § 163, the former classification is sought by taxpayers. The Laissez-Faire Approach would presumably take an attitude toward these payments that parallels the analysis of the debt-or-equity question in its permissiveness.

characterize a security in the same manner. The simplest, and most administrable, mechanism is to make the corporate issuer's characterization binding on all holders. If the issuer treats the security as debt, all holders must be constrained to do the same, and the same would be true *mutatis mutandis* for equity characterization. This condition goes beyond existing law, which makes consistent treatment presumptive, but allows security-holding taxpayers to adopt inconsistent treatment if supported by sufficient tax return disclosure.²⁰⁶

Second, consistency of timing, amounts of interest and original issue discount, follows from the same premise. Corporate deductions must be matched identically by investor inclusion both as to amount and timing. With respect to interest paid in cash, ordinary income accounting principles ensure the necessary consistency.²⁰⁷ With respect to time-value-of-money accrued but not yet paid, the existing original issue discount (OID)²⁰⁸ regime is largely sufficient to ensure the necessary consistency. Even for corporate securities containing significant risk elements that place them fairly far along the spectrum from pure debt toward pure equity, existing Treasury regulations make it possible to apply the consistent interest accrual principle. Particularly notable are OID regulations for variable rate debt instruments²⁰⁹ and contingent payment debt instruments.²¹⁰ One necessary modification is to make consistent issuer-holder treatment absolute rather than presumptive. Existing regulations for contingent payment debt instruments allow holders to adopt accrual schedules that differ from those used by issuers.²¹¹ The Laissez-Faire Approach's use of form-based debt classification to shift income from the corporate to the individual tax base calls for the elimination of that possibility.²¹²

These conditions can be put in place by explicit legislation or regulation, but in principle can also be achieved by acquiescence in administrative practice. Given the need to track consistency across all holders, the latter no doubt

206. *Id.* § 385(c). Full elimination of taxpayers' capacity to take inconsistent positions is not strictly necessary in theory but is probably necessary in practice. In principle, it should be sufficient that consistent treatment be only a condition for acceding in form-based debt classification. In practice, however, policing for consistent treatment by all security holders may impose disproportionate administrative burdens on the fisc, especially in the case of widely held securities.

207. *Id.* § 451(a).

208. *Id.* §§ 1271-1275.

209. Treas. Reg. § 1.1275-5(e) (as amended in 1996).

210. *Id.* § 1.1275-4 (as amended in 1999).

211. *Id.* § 1.1275-4(b)(4)(iv).

212. Consistency of treatment does not, however, necessarily preclude the integration of a debt instrument with a hedging position into a synthetic noncontingent debt instrument for the party taking such a hedge. *See id.*, § 1.1275-6 (as amended in 1996).

complicates the administration of the proposal. Here again, this Article remains agnostic as to the authority to act administratively.

1. *Potential Objections and Responses Thereto*

A potential objection that merits consideration is the possibility of opportunistic use of the OID rules to manipulate the timing or extent of OID accruals. A recently prominent example of such use is found in contingent convertible debt instruments. Commentators have observed the manipulation of the contingent payment debt instrument rules to accelerate or overstate deductible OID.²¹³ For a double tax regime, this manipulation is problematic because it serves to shelter a portion of corporate earnings from the corporate level of the double tax.

From an integrationist perspective, however, the permissive use of debt classification to shift income into the individual tax base makes this a nonissue. At least for taxable security holders, every dollar deducted at the corporate level is matched by a dollar of inclusion at the holder level, and it is the investor-level tax rates that are treated as normative. As such, accelerated or even exaggerated accrual of deductible OID is simply irrelevant so long as identical amounts are included in the security holders' taxable income.²¹⁴

The response to the first objection raises a second, potentially more significant objection. It is the treatment of nontaxable income recipients, namely, domestic tax-exempt persons and foreign persons that benefit from a partial or full exemption from United States taxation. Corporate earnings shielded by an interest deduction for the corporation and exempt from taxation at the investor level are not subject even to a single level of taxation. While this issue exists even under the double tax regime, permissive debt classification

213. See William S. Dixon, *Do Contingent Interest Convertible Debt Instruments Work as Advertised? Probably Not*, 15 J. TAX'N FIN. INST. 5 (2002); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 355 (2002); Lee A. Sheppard, *Contingent Interest Rules Under Pressure*, 94 TAX NOTES 1256 (2002); Lee A. Sheppard, *Cutting Off Excess Interest Accrual on Contingent Convertibles*, 93 TAX NOTES 737 (2001); Lee A. Sheppard, *The Untoward Consequences of Requiring Interest Accrual*, 91 TAX NOTES 564 (2001).

214. In principle, manipulation to delay or understate OID accruals might remain something of an issue if inside shelter is not eliminated through the taxation of all corporate income at the maximum individual tax rate. For corporations in a lower marginal tax bracket than their security holders, the understatement would save more tax at the individual security holder level than the cost of the reduced deduction at the corporate level. At the same time, however, taxpayers could take more direct advantage of inside shelter through the use of equity securities. As such, the Laissez-Faire Approach does not particularly emphasize the case for an anti-abuse regime designed to police understatements of OID.

could easily increase the amount of corporate earnings not subject to any United States taxation at all.

It is possible, however, to limit the extent of this problem without abandoning permissive debt classification. First, to the extent that the holder-level exemption is premised on the portfolio-interest exemption,²¹⁵ the existing conditions on its availability significantly restrict its expansion via permissive debt classification. In particular, the portfolio-interest exemption is not available for contingent interest,²¹⁶ thereby limiting its applicability to debt instruments that appear sufficiently "debt-like."

Another safeguard, or at least the foundation of one, is found in the Internal Revenue Code's earnings stripping limitation on interest deductions.²¹⁷ This regime limits the corporate interest deductions for amounts paid or accrued to nontaxable persons, but only to the extent that the corporation's debt-to-equity ratio is higher than 1.5 to 1, the interest expense exceeds 50% of adjusted taxable income, and a related person either holds the debt or guarantees the debt.²¹⁸ In light of permissive debt classification significantly increasing the availability of interest deductions, it might be advisable to reduce the numerical thresholds to sweep more into the deduction disallowance.²¹⁹ In addition, it might be advisable to eliminate this provision's limited applicability to related persons.²²⁰ Further adjustments may be advisable to account for the issue of nontaxable security holders. That caveat, however, should not detract from the general proposition that, from an integrationist perspective, permissive debt classification is a positive step.

215. I.R.C. §§ 871(h), 881(c) (West 2003).

216. *See id.* §§ 871(h)(4), 881(c)(4).

217. *See id.* § 163(j).

218. *See id.*

219. A number of such changes have been proposed independent of, but consistent with, the Laissez-Faire Program. The George W. Bush Administration has proposed several of these changes. First, the Administration's proposal would determine a corporation's maximum safe harbor debt level as a series of debt-to-asset ratios for various distinct classes of assets. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 104-06 (2003). The safe harbor ratios would range from a maximum of 98% for cash, cash equivalents, and securities to a low of 50% for intangible assets. *Id.* Second, it would deny the deduction of "disqualified interest to the extent that the United States members of a corporate group are more highly leveraged than the overall worldwide corporate group." *Id.* Last, it would reduce "the limitation based on adjusted taxable income . . . from 50 percent to 35 percent of adjusted taxable income." *Id.* *See also* H.R. 5095, 107th Cong. § 201 (2003) (including similar adjustments).

220. An important concern that must be considered, especially if the deduction disqualification applies outside of the related persons context, is its effect on financial businesses, for which particularly high levels of leverage are the industry norm. The Administration's proposed debt-to-asset determinations based on particular asset classes may serve significantly to ameliorate this concern. DEPARTMENT OF THE TREASURY, *supra* note 219, at 105.

2. *Debt Form Crucial*

The Laissez-Faire Approach's restriction to the use of existing legal structures serves as an important limitation on the extent to which permissive debt classification will advance the integrationist agenda. In the Laissez-Faire Approach, debt classification must be limited to securities sufficiently in debt form to allow the application of existing debt regimes. In particular, the application of the OID regime,²²¹ even for a contingent payment instrument,²²² depends upon establishing a schedule of payments over a period that ends with the maturity of the debt instrument.

Common stock, or an equivalent residual claim on a corporation's earnings, cannot satisfy the need to adhere to debt form. First, conventional common stock has no maturity date at which the investor's original capital will be repaid. While it is possible to refinance existing securities as they mature, it seems unlikely that a corporation, other than one with a preplanned termination, will be able to commit itself to refinance its entire capitalization, even if the commitment were for recapitalization in tranches based on staggered maturity dates. As such, it seems likely that every corporation will have a "permanent" component to its capital structure for which there is no expectation of a payment analogous to the maturity of a debt instrument. This junior-most tier of capital structure will not be able to avoid the form of equity.

With a bit of stretching, it is possible to minimize the depth of this bottom tier of capital structure by issuing debt-form securities with extremely long maturity periods; for example, of a century or more. Even if, in the extreme case, it were possible to replace all residual common stock with long-term securities, it is still unlikely that all of an enterprise's earnings could be shielded from the double tax regime through debt classification. The OID regime depends upon a schedule of payments to debt holders, and no enterprise, certainly no publicly traded enterprise, would commit itself to payments of its entire earnings stream.²²³

Losses present a further complication and limitation. It is certainly possible to have debt-form securities that bear some fraction of negative earnings by

221. I.R.C. §§ 1271-1275 (West 2003).

222. Treas. Reg. § 1.1275-4 (as amended in 1999).

223. Given substantial flotation costs for new issues of corporate debt or equity, satisfying corporate capital needs primarily through the retention of earnings has distinct advantages. Information asymmetries further advantage financing capital needs through the retention of earnings. See Stewart C. Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575 (1984). In addition, management self-interest may lead to excess retention of earnings. See *supra* notes 34-36 and accompanying text.

offsetting their shares of losses against their future shares of profits.²²⁴ If allocated losses reduce principal, however, under existing principles, it is implausible to characterize such an instrument as being in debt-form, and the existing OID regime depends upon a maturity date by which repayment of principal is promised.

Given permissive debt classification under the Laissez-Faire Approach, a corporation could certainly use long-term debt-form instruments for a large portion of its capital structure that would otherwise take the form of common stock. A corporation might issue a class of debt instruments with annual payments of a substantial percentage of corporate earnings, adjusted to account for claims by more senior security classes, for each year over a very long term. These securities might also bear an equivalent share of losses limited by the extent of allocated earnings. Permissive debt classification under the Laissez-Faire Approach would allow such a debt-form security to shield a large fraction of corporate earnings from the double tax regime,²²⁵ but not all of a corporation's capital structure will be eligible in this way for debt classification.

As previously noted, any realistic corporation is likely to maintain the capacity to retain indefinitely at least a portion of its earnings, and that residual claim will be represented by securities for which it is not possible to generate a schedule of payments. Moreover, there will need to be some class of security holders whose exposure to losses implies no promise of return of their invested capital.²²⁶ These securities will also have no maturity. Some of a corporation's capital structure will not be eligible for permissive debt classification. Even at its most aggressive use, therefore, characterizing debt according to form is not likely to eliminate fully the double tax burden, but it can serve as a useful step to reduce that double tax burden.

224. See, e.g., Treas. Reg. § 1.1275-4(b)(6) (as amended in 1999) (discussing similiar adjustments).

225. Whether these securities have corporate voting rights is a matter of indifference for the Laissez-Faire Approach.

226. Given that no corporate debt is fully free from the risk of nonpayment of principal, the pertinent distinction is whether nonpayment of principal invokes creditors' remedies, as in the case of prototypical debt, or no legal remedy at all, as in the case of prototypical equity. In the case of closely held enterprises, many investors are largely indifferent to this distinction because they hold overlapping debt and equity claims, and therefore, are unlikely to enforce creditors' rights in any case. See Polito, *Useful Fictions*, *supra* note 5, at 780. Permissive debt classification under the Laissez-Faire Approach is of less significance for closely held enterprises, given the availability of pass-through taxation via subchapter K, than it is for publicly traded corporations. For publicly traded corporations, permissive debt classification is likely to lead to an increased use of "hybrid" debt instruments. See Polito, *Useful Fictions*, *supra* note 5, at 779. It seems likely that any publicly traded corporation will have at least some class of securities for which loss of invested capital does not invoke creditors' remedies.

3. *Tax Preference Items*

The treatment of various tax preferences is a significant issue worth noting in connection with permissive debt classification. While some integration proposals would require a shareholder-level tax on the distribution of these earnings, others would allow for tax-exempt corporate income to be distributed without triggering a shareholder-level tax.²²⁷ Pure integrationism treats preferences as a distinct question from the integration question. It does not address the wisdom of any particular tax benefit, but it does posit that taxpayers ought to be equally eligible for preferences regardless of the legal form in which their businesses are conducted. As such, an idealized pass-through paradigm of integration would pass the benefit of tax-exemption and most other tax preferences on to shareholders.²²⁸

Advancing integration through permissive debt classification resolves that issue automatically, in a manner that is contrary to the ideal of pure integrationism. Corporations may effectively deduct amounts classified as interest and OID only against gross income; that is, against amounts otherwise taxable at the corporate level. The regime simply shifts income fully taxable at the corporate level into the investor tax base by making it deductible against amounts otherwise taxable at the corporate level. Corporate preference income remains fully taxable at the investor level whether distributed as dividend or interest. Some of the other elements of the Laissez-Faire Approach have the contrary characteristic of passing through corporate-level preferences to individual taxpayers. Whether to emphasize permissive debt characterization or other aspects of the Laissez-Faire Approach will therefore depend, in part, upon how this issue of preference items is resolved.

227. Compare TREASURY STUDY, *supra* note 12, at 15-20, 63-65 (recommending against the extension of integration benefits to tax preference items) with ALI STUDY, *supra* note 12, at 108-12 (proposing that the benefit of specified corporate tax exemptions and tax credits be passed on to shareholders in integration). See also Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 TAX LAW. 195 (1990) (analyzing the methods eight industrialized countries use to limit the pass-through of preferences in integration).

228. See, e.g., CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE?, 131-32 (1979) (arguing that investment tax credits should be passed through to shareholders); Harry M. Kitchen, *Canada*, in COMPARATIVE TAX SYSTEMS: EUROPE, CANADA AND JAPAN 341, 360 (Joseph A. Pechman ed., 1987); Polito, *supra* note 98, at 1036-37 (arguing that tax preferences given to corporations should be retained "but only to the extent . . . available to taxpayers who do not avail themselves of the corporate form").

4. *Consistent with Existing Planning Opportunities*

The use of permissive debt classification to advance the integrationist agenda is very much consistent with other methods of using leverage as a form of self-help integration. For example, Robert Scarborough has outlined the manner in which a corporation can replace admitted equity with synthetic equity created by issuing debt securities and separate derivative products based on its own equity. To the extent that the existing tax regime does not compel the integration of the separate debt and derivative securities, “[a] corporation that substitutes debt and derivatives for equity will have effectively integrated the corporate and investor-level taxes on the time-value return from capital subject to the risks of its business.”²²⁹ Likewise:

[T]he proliferation of trust-preferred securities and other similar hybrid devices permit corporate managers to issue dividends in the form of deductible interest payments. Under the typical arrangement, the corporation forms a tax-exempt subsidiary to issue preferred stock to the public. The subsidiary then loans the proceeds of the stock issuance to its parent corporation. This allows the parent to pay tax-deductible interest to the subsidiary, which in turn uses the interest payments to fund the preferred dividend to shareholders. The corporation receives a deduction and, in many cases, the loans are not treated as debt on the corporation’s books because of the equity status of the preferred shareholders. Shareholders are taxed on the dividends received, but the effect is a do-it-yourself integration of the corporate and shareholder income taxes.²³⁰

Other such self-help techniques no doubt already exist or are soon to be uncovered by clever tax planning professionals.

From the perspective of the Laissez-Faire Approach, the tax regime should quietly acquiesce in these uses of debt form to advance the integrationist agenda. Aggressive enforcement action to counter these forms of self-help integration is counterindicated from that perspective. Further, legislative attempts to block these forms of self-help integration should be avoided.

229. Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income*, 55 TAX L. REV. 465, 529 (2002).

230. Steven A. Bank, *Rethinking Double Taxation’s Role in Dividend Policy: A Historical Approach*, 56 TAX L. REV. 463, 521–22 (2003) (footnotes omitted).

VI. INTERCORPORATE DIVIDENDS—EXPANDED DIVIDENDS-RECEIVED DEDUCTION

Under existing law, the dividends-received deduction²³¹ serves to ameliorate the phenomenon of the cascading tax, in which income tax is imposed on corporate earnings in the corporation in which earned and again at each corporate level through which the earnings pass as dividends before their ultimate distribution to individuals. Given that the Laissez-Faire Approach is premised on the defectiveness of a double tax regime, a mechanism that prevents triple or higher multiples of taxation of the same income is unobjectionable. Nevertheless, there are two aspects of the existing dividends received deduction regime that are appropriate targets of adjustment.

The first is the limited availability of full dividends-received deduction. Under section 243, the full amount of dividend received is deductible by a parent corporation receiving the distribution from a subsidiary corporation meeting the 80% share ownership requirements for membership in an affiliated group.²³² Dividends received from corporations that do not meet the 80% subsidiary threshold are generally limited to 80% or 70% deductibility.²³³ From the integrationist perspective, it is the possibility of inside shelter²³⁴ of corporate earnings that justifies denying the full dividends-received deduction to distributions that move earnings among corporate entities but do not trigger a shareholder-level tax. If the benefit of inside shelter is eliminated,²³⁵ this justification falls away. All taxable corporate income will have been subject to taxation at the maximum individual rate, and further taxation of those earnings as they move as dividend distributions within corporate form ought not to trigger further taxation. As such, the Laissez-Faire Approach appropriately includes an amendment to apply a 100% dividends-received deduction to all cases governed by section 243.²³⁶

A second issue concerns the taxation of corporate sales of stock of other corporations. Given that a portion of the value of any share of stock represents its claim on accumulated earnings, the taxation of corporations for the full gain

231. I.R.C. § 243 (West 2003).

232. *Id.* §§ 243(a)(3), 243(b)(1). The 100% dividends-received deduction is also available in the case of dividends received by a small business investment company. *Id.* § 243(a)(2).

233. *Id.* §§ 243(a)(1), 243(c).

234. *See supra* notes 153–68 and accompanying text.

235. *See supra* notes 182–85 and accompanying text.

236. A conforming amendment would substitute 100% for 70% in the formula for deduction of dividends received on preferred stock. *See, e.g.*, I.R.C. § 244 (West 2003) (substituting 70% for 100% deductions in the case of preferred qualifying dividends). These amendments would not affect the limitation of the deduction to distributions out of U.S. source earnings subject to U.S. taxation for distributions from foreign corporations. *Id.* § 245.

recognized on the disposition of stock represents a cascading tax to the extent of the claim on earnings. In principle, that portion of the disposition gain ought not to be taxable to the selling corporation, even in a double tax regime. Unfortunately, the complexity of allocating undistributed earnings among corporate shares²³⁷ forecloses the possibility of a simple statutory remedy.

Taxpayers, however, have attempted a self-help resolution in the case of a subsidiary sale. Consider the following scenario: *Parent corporation* plans to sell its wholly owned *subsidiary corporation*. *Subsidiary corporation* declares a dividend for the entire balance of its earnings and profits account and distributes the dividend in the form of a promissory note. *Parent corporation's* basis in the note is its face value.²³⁸ Purchaser acquires not only the *subsidiary corporation's* stock, but also the promissory note paying face value for the note. If the dividends-received deduction applies, *subsidiary corporation's* earnings have been transferred without further corporate taxation.

Even under a double tax regime, this is the appropriate result, but it does not apply in every case. The scenario presented is a stylized description of the facts of *Waterman Steamship Corp. v. Commissioner*,²³⁹ in which the substance over form doctrine served to recharacterize the dividend distribution as a portion of the sales price subject to capital gains taxation. Whatever may be said for or against the substance over form doctrine more generally,²⁴⁰ its application in this context is inappropriate.²⁴¹ For the Laissez-Faire Approach, *Waterman Steamship* ought to be set aside.²⁴²

237. See *supra* notes 97-101 and accompanying text.

238. See I.R.C. § 301(d) (West 2003). Given that the note is about to be purchased at its face value as part of the sale of *subsidiary corporation*, there is no reason in this context to question whether its face value is also its fair market value.

239. 430 F.2d 1185, 1185-87 (5th Cir. 1970). A slight variation is one in which distributing a note for the full amount of earnings and profits reduces the value of the stock enough to generate a loss on the sale of the subsidiary. This loss ought not to be considered an artificial loss. The earnings and profits portion of the stock value has already been subject to corporate level taxation. The existence of an earnings and profits account greater than the excess of share value over basis calls for an offsetting loss at the parent level in an idealized integrationist paradigm.

240. See, e.g., Joseph Isenbergh, Review, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863 (1982) ("several of the touchstone cases on form and substance in taxation are flawed in principle and serve neither taxpayers nor the Treasury"); Polito, *supra* note 17, at 575 (arguing the relevant inquiry is how to reconcile the detailed rules adopted by Congress instead of determining the true substance of the transaction).

241. See Charles I. Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861, 867-73 (1976) (arguing that the substance over form doctrine should not apply in these circumstances because a dividend distribution lacks independent economic substance).

242. 430 F.2d at 1194 (following substance over form doctrine by holding that a declaration and payment in the form of a promissory note by a subsidiary to its parent corporation constituted part of the purchase price). It is clear that Congress could reverse *Waterman Steamship* legislatively, and the Supreme Court has the authority to reject the principle for which it stands.

VII. CAPITAL GAINS RATE BAILOUTS

For a regime in which double taxation of corporate earnings is normative, the potential to bailout corporate earnings at capital gains rates is problematic. From a double taxation perspective, all corporate earnings ought to be subject both to corporate-level taxation and to shareholder taxation at the full ordinary rates. The application of preferential capital gains rates to stock sales opens the possibility of “disguising” earnings distributions as sale transactions. The unsurprising offspring of this pairing is the rise of multiple tax regimes that police against taxpayer schemes that “inappropriately” produce these capital gains rate bailouts.²⁴³ From an integrationist perspective, however, these regimes are yet another set of solutions in search of a problem.

The 2003 Tax Act, at least until 2008, makes the capital gains tax rate the norm for most dividend distributions.²⁴⁴ A very similar result can be achieved by setting aside the existing regimes designed to prevent capital gains rate bailouts. From the Laissez-Faire Approach, setting aside those regimes is useful regardless of the post-2008 fate of the 2003 Tax Act’s dividend relief. If the legislative majority is not available to extend the 2003 Tax Act, much the same result can be achieved by eliminating these antibailout regimes. If these antibailout regimes are successfully set aside before the expiration of dividend relief under the 2003 Tax Act, the chances of that Act becoming permanent are likely to rise. If the 2003 Tax Act is made permanent, these regimes are, from an integrationist perspective, largely unnecessary and ought to be eliminated. This analysis outlines the antibailout regimes that the Laissez-Faire Approach marks for elimination regardless of what becomes of the 2003 Tax Act’s sunset provision.

A. *Stock Redemption Capital Gains Rate Bailouts*

Consider first the simplest scenario: the corporate redemption of its own stock. Existing law sets forth elaborate and intricate tests to determine whether such a redemption is to be treated as a stock sale or as a dividend.²⁴⁵ From an integrationist perspective, there is no need to classify a redemption as a dividend at all. If a corporation redeems its own stock for cash, there are three

It is not clear whether the Service has the authority to disregard it for future subsidiary sale cases. Once again, however, this Article brackets the question of what mechanisms for achieving the proposed action are legitimate. *See supra* notes 151-52 and accompanying text.

243. I.R.C. §§ 302, 304-306, 356(a)(2) (West 2003).

244. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302-303, 117 Stat. 752, 760-64.

245. I.R.C. § 302 (West 2003).

possible sources of the redemption price: (1) shareholder's invested capital; (2) corporate earnings; or (3) third-party loans in excess of the first two.

Shareholders' invested capital ought not, in any case, to be subject to shareholder level taxation. Even the existing dividend regime acknowledges this and allows for the classification of some distributions as tax free return of shareholder capital, which is all treated as after tax amounts. Existing stacking rules for dividends insist that return of capital is recognized only to the extent that corporate earnings and profits are exhausted.²⁴⁶ If a stock redemption is treated as a sales transaction, the stacking is reversed.²⁴⁷ Distributed cash is applied first against the shareholder's basis in the stock and as gain from sale only to the extent of the excess. From an integrationist perspective, however, this second stacking convention is the better of the two. Capital return is tax-paid value, and from an integrationist perspective, corporate earnings and profits are also tax-paid value.

If the redemption is funded out of earnings and profits, the amount distributed has already been subject to corporate level taxation. From the integrationist perspective, the imposition of a shareholder-level tax, because the amount paid exceeds shareholder basis, is an excess tax burden, even if it is imposed at the capital gains rate. As such, there is no need to treat the shareholder receipt as a dividend taxable at the full shareholder-level rate.²⁴⁸

Distributions of borrowed cash in excess of corporate earnings and shareholders' invested capital represent amounts that have not been subject to previous taxation at either corporate or shareholder level. To the extent that the borrowing is in anticipation of future corporate realization of capital gains amounts, the shareholder-level capital gains tax is, from an integrationist perspective, a sufficient tax. The future corporate-level tax, however long deferred, is an excess tax burden.

To the extent that the borrowing is in anticipation of corporate realization of ordinary income, the shareholder-level capital gains tax is an undertax. At some time, however, the corporation presumably will need to recognize the ordinary income items, which will trigger full taxation at the corporate level at that future time. Even if the debt-funded redemption is viewed as the proper

246. *See id.* § 301(c) (treating distributions as shareholder basis reduction only to the extent that distributions exceed current and accumulated earnings and profits).

247. *See id.* § 1001.

248. Allowing capital gains rate distribution of corporate preference rate income implies the automatic partial pass-through of corporate preferences. If inside shelter is not fully eliminated, the inside shelter will tend to mitigate the extent of the excess tax burden for distributing after tax earnings at capital gains tax rates. In some cases, it is possible that the benefit of inside shelter may exceed the cost of distribution at deferred capital gains rates. Whether this shelter possibility should be eliminated entirely is no different than the question of eliminating inside shelter in general. *See supra* Part IV.

taxing moment, the integrationist still views a single level of taxation as the ideal. In that sense, the additional deferral at the corporate level at least partially offsets, in present value terms, the excess tax burden of imposing tax at both corporate and shareholder levels. In some cases the additional deferral will be a partial correction, and in other cases, an "excessive" correction. The additional deferral will correct to the effect of a single level of tax only by happenstance. Given the possibility of undercorrection in these cases and the overtax in capital gains asset cases, the debt-funded redemption scenario should not be problematic to the Laissez-Faire Approach.

Even under existing rules, many shareholders can themselves borrow against the value of their shares without current recognition of income.²⁴⁹ Doing so is a well-known technique for gaining access to liquidity without current taxation.²⁵⁰ The ultimate need to repay out of tax-paid income will measure the extent of deferral. To the extent that shareholder borrowing is a realistic alternative, allowing the corporation to borrow in order to fund redemptions

249. See, e.g., *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952) (concluding that a nonrecourse secured borrowing transaction is not a realization event and does not increase the taxpayer's basis in the property securing the debt). Likewise, an early Treasury Regulation provides that "[i]f bonds are issued by a corporation at their face value, the corporation realizes no gain or loss." Treas. Reg. 62, Article 545 (1922). A further indication of the longstanding nature of this principle is the early vintage of the doctrine that cancellation of debt constitutes income, a doctrine premised on the assumption that the receipts of a cash borrowing transaction are not subject to tax. For example, the same Treasury Regulation quoted above provides that if "the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." *Id.* See also *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931) (holding that a corporation recognizes income to the extent that it repurchases its own bonds for less than their issue price). See Polito, *supra* note 17, at 481-513 (setting forth an extensive consideration of the issue of nontaxable borrowing transactions).

250. Promotional literature of the Private Client Services Group of Goldman, Sachs & Co. indicates that:

This Group is routinely asked to make presentations for clients who own concentrated stock positions on the innovative strategies that are available to monetize, diversify or hedge a stock position without selling the stock and incurring a taxable gain . . . [and the] alternatives available to a client with low basis stock, including the following:

- Borrow against your stock
- Exchanging the return of your stock for the return of a diversified portfolio
- Exchanging your stock for shares in a diversified fund
- Executing a short sale or a synthetic sale and reinvesting the proceeds in a diversified portfolio
- Selling unregistered shares to Goldman Sachs
- Hedging your risk with over-the-counter options.

Goldman, Sachs & Co. Promotional Material (June 6, 1994) (on file with the author) (emphasis added).

that trigger capital gains taxation at the shareholder level would provide significantly less deferral benefit than allowing nontaxable shareholder borrowing against the value of their own shares.

From an integrationist perspective, capital gains treatment for cash redemption transactions is, on balance, unproblematic in the sense that it is nearer to the ideal than is dividend treatment of those transactions.²⁵¹ What about redemptions in exchange for property? Existing law requires corporations to recognize gain with respect to appreciated property just as if the property were sold for its fair market value. To obtain capital gains treatment at the shareholder level, the corporation would need to trigger a recognition event at the corporate level. As such, the existing mechanisms for converting redemption transactions into dividends for tax purposes are not necessary. For the Laissez-Faire Approach, section 302, which currently specifies which corporate redemptions qualify for sale treatment, could be safely amended to read that all stock redemptions are to be treated as stock sales.²⁵²

1. Corollary Provisions

This modification safely allows for the outright repeal of provisions that prevent attempts to bypass existing section 302. Section 303 allows limited sale treatment for redemptions in connection with the settling of estate taxes.²⁵³ The proposed amendment to section 302 would make it redundant. Section 304 subjects stock purchases through related corporations to the dividend equivalence tests of section 302.²⁵⁴ With the elimination of those tests, it serves

251. It seems likely that many publicly traded corporations are already able to produce this functional result via open market purchases of their own shares. Given the anonymity of modern public markets, it is difficult, if not impossible, to distinguish open market sales in which the purchaser is the issuer from those in which the purchaser is a third party. As such, applying the statutory tests for dividend-equivalence is not practicable, and these transactions are undoubtedly treated as capital gains transactions. Professor Grullon has observed the increasing use of share repurchases and the declining fraction of total earnings distributed as dividends. Nevertheless, his data show large-scale simultaneous use of both. Grullon, *supra* note 33, at 29 (citing COMPUSTAT, the Standard & Poor's database service, at <http://www.compustat.com>).

252. A partial reinstatement of the *General Utilities* doctrine, *see infra* Part X, proposes to premise lack of corporate level tax on a distribution of appreciated property only if it is subject to a full dividend level tax at the shareholder level, which is sufficient tax from the integrationist perspective. As such, under the limited *General Utilities* reinstatement, corporations would likely generally bypass the corporate level gain by triggering the shareholder-level taxable dividend. Stock redemptions for appreciated property would be rare because, even if treated as capital gains transactions for shareholders, they would be less tax effective to the corporation and, for that reason, unproblematic to the tax law. As such, even the limited *General Utilities* reinstatement should pose no obstacle to the proposed amendment to I.R.C. § 302.

253. I.R.C. § 303 (West 2003).

254. *Id.* § 304.

no useful purpose. The same is true for section 306. The so-called preferred stock bailout,²⁵⁵ against which it is set, is simply irrelevant in a regime in which common stock can be redeemed at capital gains rates. In the Laissez-Faire Approach all three of these provisions should be repealed.

In addition, the modification of section 302 suggests a parallel adjustment to the treatment of taxable boot consideration in otherwise tax-free corporate reorganizations. The existing regime polices against reorganization boot serving the same end as a dividend disguised as a stock redemption. Whether a distribution of boot has the effect of a dividend distribution²⁵⁶ is determined by use of the dividend-redemption tests under existing section 302.²⁵⁷ From an integrationist perspective, the bailout of corporate earnings at capital gains rates is no more problematic than in the commonplace stock redemption circumstance. The applicable provision²⁵⁸ should be repealed. Even if it is not, the proposed modification of section 302 may have the same effect by abolishing the tests that serve to treat boot distributions as having the effect of a dividend distribution.

2. Liquidation-Reincorporation Transactions

As a corollary, the Laissez-Faire Approach counsels abolishing the "non-divisive D reorganization"²⁵⁹ and with it the liquidation-reincorporation doctrine. From the double taxation perspective, the combination of a

255. In the classic preferred stock bailout, a corporation distributes a class of redeemable non-voting preferred stock on a pro rata basis to its existing common stockholders. The distribution itself is not taxable, *Id.* § 305(a), and the shareholders reallocate a fraction of their basis from common stock to the preferred stock, *Id.* § 307(a). The shareholders sell the preferred stock to a third party at par value, recognizing taxable gain at capital gains rates. The preferred stock has no voting rights and its sale to the third party purchaser has no effect on corporate control. Later, the stock is redeemed at par, but because the third party purchaser takes a basis in the preferred stock equal to its par value, its taxable income is limited to the preferred stock dividends. In effect, the original shareholders have received corporate earnings at capital gains rates without losing any voting control of the corporation. See *Chamberlin v. Commissioner*, 207 F.2d 462, 472 (6th Cir. 1953).

256. See I.R.C. § 356(a)(2) (West 2003) (stating that if an exchange has the effect of the distribution of a dividend it is taxable as such).

257. *Commissioner v. Clark*, 489 U.S. 726, 732-34 & nn. 5-6 (1989). In as much as *Clark* adopted an interpretation of I.R.C. § 356(a)(2) less likely to produce dividend treatment than an alternate interpretation available to the Court, see *Shimberg v. United States*, 577 F.2d 283, 286 (5th Cir. 1978) *cert. denied*, 439 U.S. 1115 (1979), it advances the integrationist agenda and is consistent with the Laissez-Faire Approach.

258. See I.R.C. § 356(a)(2) (West 2003).

259. The repeal would be effected by repealing reference to I.R.C. § 354 in I.R.C. § 368(a)(1)(D) and vice versa. In addition, the applicable definition of corporate control, I.R.C. § 368(a)(2)(H)(i), would be subject to repeal as being redundant.

liquidation and the reincorporation of the corporation's operating assets, minus the former corporation's earnings, is problematic. This allows earnings to be removed from the corporation at capital gains rates. The so-called "non-divisive D reorganization" polices against this possibility. The liquidation-reincorporation transaction is treated as a "tax-free" reorganization,²⁶⁰ in which the unreincorporated assets are taxable boot that is normally taxable at ordinary income tax rates.²⁶¹ The proposed elimination of dividend treatment for boot in reorganizations would effectively negate the effect of this regime, suggesting in turn the outright abolition of the "non-divisive D reorganization." Removing previously taxed earnings at capital gains rates is not problematic for the Laissez-Faire Approach.²⁶²

B. Changes in Proportional Ownership

If all stock redemptions are treated as sales, it is possible for a corporation selectively to redeem stock from shareholders who prefer additional cash at the cost of triggering capital gains taxation.²⁶³ Even without more, such a program would increase the proportionate ownership shares of nonredeeming shareholders, without current taxation for shareholders increasing their proportionate interests in the corporation's assets and earnings. The question naturally following is whether that prospect should be seen as troubling for the Laissez-Faire Approach.

From a double taxation perspective, tax-free increases in proportionate equity can be seen as economic substitutes for the reinvestment of dividend distributions. The fractionally increased share in the corporation can be redeemed later or sold at capital gains tax rates. The double taxation perspective finds this combination of tax treatments troubling because it allows the possibility of reducing the ordinary, second-level tax rate on dividends to capital gains taxation. It is for this reason that many stock dividends are treated as ordinary taxable dividend distributions.²⁶⁴

For the full pass-through model of partnership taxation, selective distributions by the partnership present a problem solely because income character as ordinary and capital gains is passed through to partners. Each

260. *Id.* §§ 368(a)(1)(D), 354(b)(1).

261. *See id.* § 356.

262. *See supra* Part VII, section A.

263. *See supra* note 251 (discussing Professor Grullon's observations).

264. I.R.C. § 305(b)-(c) (West 2003). Moreover, the double taxation perspective treats a transaction equivalent to the reinvestment of cash dividends as an appropriate circumstance to impose the second level of tax on corporate earnings, even if every shareholder elects to receive stock. *See id.* § 305(b)(1).

partner is expected to share in both capital and ordinary income character assets, and therefore, distributions that allow individual partners to avoid their shares of ordinary income are problematic.²⁶⁵

For the Laissez-Faire Approach, however, these issues are not a concern. The Laissez-Faire Approach accepts the double taxation of earnings in some circumstances only because it seeks to avoid the complexity and burden of establishing full integration. To the extent it is not able to eliminate the shareholder-level second tax on earnings, it views that tax as excess tax burden. As such, increases of proportional interests that convert ordinary dividends to capital gains are not problematic. Moreover, the Laissez-Faire Approach is not a partnership model full pass-through regime. Character of individual items is accounted for at the corporate level;²⁶⁶ therefore, changes in shareholders' economic claims on individual corporate assets pose no special problem.

Thus, for the Laissez-Faire Approach, capital gains taxation for selective stock redemptions does not present any concerns with respect to the nonredeeming shareholders. Redemptions for some shareholders never need to result in taxation for nonredeeming shareholders.²⁶⁷ By extension, stock dividends should never be taxable, regardless of how they affect proportionate interests or whether they are optional in lieu of cash or property dividends.²⁶⁸ The existing Code's treatment of stock dividends may be limited to the general rule of nontaxation for stock dividends.²⁶⁹

C. Spin-Off Transactions

A further target for reform under the Laissez-Faire Approach is the nontaxable spin-off transaction. The prototypical spin-off transaction allows a single corporate enterprise to be split into two or more corporate entities, either by the distribution of the stock of one or more existing subsidiaries to shareholders, or by the transfer of corporate assets to one or more newly formed subsidiaries immediately before the distribution of the new subsidiary stock to

265. *See id.* § 751.

266. Existing law does provide for a corporate capital gains preference, but it is of minimal significance, applying only to corporations with a marginal tax rate of more than 35%. *See id.* § 1201(a). If the benefits of inside shelter are eliminated via the imposition of single corporate tax rate, *see supra* notes 182-85 and accompanying text, there would be no capital gains preference for corporate asset sales.

267. *Contra* I.R.C. § 305(c) (West 2003) (authorizing dividend taxation of nonredeeming shareholders if redemptions for other shareholders are treated as dividends and the combined effect is to alter proportionate interests).

268. *Contra id.* § 305(b), (c).

269. *Id.* § 305(a). This change would no doubt need to be effected by the Congressional repeal of subsections (b) and (c) of section 305.

shareholders.²⁷⁰ Under existing law, all of these transactions are nontaxable transactions, where untaxed gain is preserved for subsequent taxation,²⁷¹ but only if a number of specific conditions are satisfied.

Under a double-tax regime, a significant concern is that the spin-off transaction will be used to isolate liquid assets or passive investments in a separate corporate entity from the operating business as a preparatory step to the disposition of the liquid-asset corporation's stock at capital gains rate. Such a bailout technique would give shareholders access to the value of earnings and profits at capital gains tax rates, which is problematic for a double-tax perspective. Given, however, that the Laissez-Faire Approach has no objection to the bailout of corporate earnings and profits at shareholders' capital gains tax rates and seeks intentionally to facilitate that practice,²⁷² limitations on spin-off transactions are unnecessary to the extent that they serve to prevent that very end. The first most obvious candidate is the requirement that the transaction not be used principally as a device for the distribution of earnings.²⁷³ This restriction is unnecessary from the integrationist perspective and should be repealed.

A second candidate is the active-business requirement²⁷⁴ which requires, in general, that both the corporation distributing stock and the controlled corporation²⁷⁵ be engaged (at the time of the distribution) in an active trade or business that was not begun or purchased within the five years immediately preceding the distribution.²⁷⁶ The primary function of this provision is to prevent the bailout of earnings and profits at capital gains rates. It does so by

270. In the former case, the transaction is a "pure" spin-off. In the latter case, it is termed a "divisive D reorganization," *see id.* § 368(a)(1)(D). An alternative form is the "split-off" in which the stock distribution is exchanged for existing stock and/or non-pro rata among existing shareholders. A further alternative is the "split-up" in which stock of two or more subsidiaries is distributed in exchange for all of the stock of the distributing corporation. The distributing corporation thereby liquidates, and it is completely replaced by the corporations whose stock is distributed. *See id.* § 355(a)(2); *see also* DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 647-49 (4th ed. 1994) (explaining the differences between "spin-offs," "split-offs and split-ups"). For purposes of this Article, the term "spin-off" is used as a general term to refer to all of these related transactions.

271. I.R.C. § 358(a)-(c) (West 2003) (allocating predistribution basis between stock retained in the distributing corporation and stock received in distributed corporation).

272. *See supra* Part VII, Section A.

273. I.R.C. § 355(a)(1)(B) (West 2003).

274. *Id.* § 355(a)(1)(C).

275. The term "controlled corporation" refers to the corporation whose stock is distributed. *Id.* § 355(a)(1)(A). The term is used in that sense throughout the discussion of spin-off transactions.

276. *Id.* § 355(b). The requirement is also satisfied if the distributing corporation was purely a holding company predistribution and each of the spun-off subsidiaries meets the active business requirement. *Id.* § 355(b)(1)(B).

preventing a corporation from converting earnings and profits into a distinct business for the purpose of spinning-off the new business in a form that allows its disposition at capital gains rates. In this regard, the provision is unnecessary from the perspective of the Laissez-Faire Approach and should also be repealed.²⁷⁷

Another set of issues relates to the two structures targeted at the use of a spin-off as a step in a plan to dispose of control of either the distributing corporation or the controlled corporation either in advance of the spin-off distribution or after the spin-off distribution.²⁷⁸ These provisions are based on the premise that, in a double tax regime, a disposition of a part of a corporation's enterprise ought to trigger corporate-level taxation. For the Laissez-Faire Approach, these provisions raise two distinct sets of questions: timing of gain taxation and character of gain taxation.

The timing issue relates to whether the structured combination of a nontaxable spin-off of assets and a disposition should terminate tax deferral at the corporate level. The stock disposition leg of the transaction is either a nontaxable reorganization²⁷⁹ or a taxable stock disposition, which is normally taxable at capital gains rates. Given the integrationist paradigm of a single level of tax at the tax rates that would apply to shareholders if they held the corporate assets directly, it cannot be said that the full normative tax burden will have been imposed in every case. In some cases, the tax will have been deferred entirely, and in another set of cases stock representing claims on ordinary-income assets will have been disposed of at capital gains rates. At some time, however, the corporation will presumably need to dispose of the assets, which will trigger full taxation at the corporate level at that future time.²⁸⁰

If this theory is true, the question is whether the use of the spin-off to dispose of a portion of the corporate assets should end the deferral of the corporate-level taxation. One view is that the disposition of the entire corporation would not necessarily trigger corporate-level gain under the existing regime, and therefore, the stock disposition of a portion of the corporation is no more justifiable an occasion for a corporate-level realization. Even if the spin-off-connected disposition is viewed as the proper taxing

277. Elimination of these requirements also suggests a significant liberalization of the "business purpose" requirement. Treas. Reg. § 1.355-2(b) (as amended in 1992).

278. I.R.C. § 355(d)-(e) (West 2003); *see also* BITTKER & EUSTICE, *supra* note 16, § 11.11[2]-[3] (noting that the purpose of § 355(d) is to prevent "disguised corporate-level tax free 'sales'" through the use of § 355 dividends).

279. I.R.C. § 368(a) (West 2003).

280. If appreciated assets are distributed via the limited reinstatement of the *General Utilities* doctrine, the disposition will generate only a single level of tax, which is at the shareholder level tax rates. *See infra* Part X. From an integrationist perspective, however, that tax is a sufficient single tax.

moment, the integrationist still views a single level of taxation as the ideal. In that sense, the additional deferral at the corporate level at least partially offsets, in present value terms, the excess tax burden of imposing tax at both corporate and shareholder levels. The additional deferral will be a partial correction in some cases and an “excessive” correction in other cases. The additional deferral will be a correction that effects a single level of tax only by happenstance. Given that the Laissez-Faire Approach addresses itself primarily to the elimination or reduction of the excess corporate tax burden, and not to the question of timing and deferral, the approach should remain agnostic as to this question.

A potential problem of characterization arises out of the interaction of not triggering corporate-level gain in these spin-off-connected dispositions and eliminating the active business requirement for nontaxable spin-offs. Without an active business requirement, it is conceivable that ordinary-income assets, insufficient to constitute an active business, could be spun-off and sold without triggering a full, ordinary rate tax.²⁸¹ Even if a capital gains tax is triggered at the shareholder level, it is possible that successive transfers of these assets through stock sales could be used to defer full, ordinary rate taxation indefinitely. Such a stratagem might come very near to the conversion of ordinary income assets into capital gains assets. For this reason, it should be consistent with the Laissez-Faire Approach’s premises to retain the corporate-level taxation for spin-off-connected dispositions if the active business requirement is eliminated; or instead, to retain the latter and eliminate the former. In the alternative, the existing recognition regimes for spin-off-connected dispositions could be modified to impose recognition of gain only to the extent of the net appreciation for ordinary income assets effectively disposed of in the spin-off-connected transaction.

D. The Foreign Shareholder Problem

A potential objection relates to the taxation of foreign taxpayers. Dividends are United States source income if paid by United States corporations or foreign corporations with substantial United States source income.²⁸² Sale of corporate stock, however, is generally sourced to the residence of the taxpayer.²⁸³ A permissive policy of allowing corporations to convert dividends into stock sales could have the effect, therefore, of

281. A corporation might use this technique to spin-off and sell assets such as accounts receivable or inventories.

282. I.R.C. § 861(a)(2) (West 2003).

283. *Id.* § 865.

converting taxable United States source dividends into non-taxable foreign-source stock sale transactions.

A relatively simple correction to this problem would be to treat a stock sale as generating United States source income if dividends distributed by the same corporation would be United States source income. This resolution is potentially subject to the criticism of being overbroad because it would impose United States source income treatment on "legitimate" stock sales that would generate foreign-source income under existing law. Public trading of stock, however, could mitigate this problem. Closely held enterprises already have the option of pass-through treatment,²⁸⁴ and the double tax regime is mandatory only for publicly traded enterprises.²⁸⁵ As such, this sourcing rule would be avoidable by all but publicly traded corporations. The liquidity and record keeping of public trading mitigates the harshness of imposing United States sourcing. Stockbrokers could be made responsible to withhold a tax on the gain or the gross sales price if sellers fail to report basis numbers.

Nevertheless, it might be desirable to create a more narrowly focused resolution. Characterization as United States source income might be targeted to distributions from a corporation as part of a liquidation or in redemption of its own stock or a related company's stock, but only if a dividend by the paying corporation would be United States source income. Stock received in tax-free distributions could be marked to generate United States source income on disposition, or the tax-free character of the distribution could be limited to distributions to shareholders subject to United States worldwide taxation. The value of greater refinement needs to be balanced, however, against a concern about reintroducing legal and administrative complications paralleling those targeted for elimination under the Laissez-Faire Approach. Regardless of how closely targeted these refinements should be, the problem of foreign shareholders should not detract from the general proposition that, from an integrationist perspective, permissive stock sale treatment for redemptions is a positive step.

VIII. FORMER COLLAPSIBLE CORPORATION REGIME

Another issue that poses a problem for a double-taxation perspective, but that was never a real problem for an integrationist, is the collapsible corporation. Congress, however, has addressed this issue and acted—temporarily at least—in a manner consistent with the Laissez-Faire Approach. From the double-taxation perspective, a business operated in

284. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

285. See I.R.C. § 7704 (West 2003).

corporate form should generate operating profits taxable as ordinary income at the corporate level and, by and large, dividends taxable as ordinary income at the shareholder level. The combination of the historic *General Utilities* doctrine²⁸⁶ and the treatment of liquidations, however, made it possible to bypass this treatment. The shareholders of a liquidating corporation recognized capital gains income on the surrender of their shares. The corporation recognized no gain or loss on the liquidating distribution because of the *General Utilities* doctrine, but the shareholders received a fair market value basis in the property. Shareholders were then able to sell the distributed property without recognizing further gain. In effect, the collapsing of the corporation converted a double-level ordinary income rate tax regime into a single-level capital gains rate regime.²⁸⁷

Congress responded with the collapsible corporation provision,²⁸⁸ which reverses this result for:

[A] corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of [ordinary income property or trade or business property held for less than three years] . . . or for the holding of stock in a corporation so formed or availed of, with a view to—

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of 2/3 of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.²⁸⁹

From the integrationist perspective of the Laissez-Faire Approach, however, this provision is entirely unnecessary. Under existing law, the removal of assets from the corporation, by liquidation or otherwise, triggers two levels of

286. See *Gen. Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

287. See, e.g., KAHN & LEHMAN, *supra* note 270, at 374-76 (discussing the use of a “collapsible” corporation as used prior to the repeal of the *General Utilities* doctrine.) An alternative route to the same result was the disposition of the corporation’s stock at capital gains tax rates, permitting the liquidation of the corporation without further taxation. *Id.*

288. I.R.C. § 341 (West 2003).

289. *Id.* § 341(b)(1).

taxation. The liquidation of the corporation results in the imposition of a corporate-level tax on unrealized appreciation in assets²⁹⁰ and a capital gains tax on the surrender of shareholders' stock.²⁹¹ From an integrationist perspective, this results in more than the ideal tax, which would be a single level of tax. In short, the Laissez-Faire Approach counsels that Congress was right to repeal the collapsible corporation rule²⁹² and would have been right to do so even if it had not acted to subject dividends temporarily to capital gains tax rates.²⁹³ For the Laissez-Faire Approach, the only remaining objection is the scheduled sunset of the repeal.²⁹⁴

IX. PENALTY TAX REGIMES

Concerns about retention of earnings within corporate solution are largely nonexistent from an integrationist perspective. If inside shelter is fully eliminated,²⁹⁵ the full normative tax, and perhaps more, will be borne by all corporate earnings. As such, mechanisms designed to limit the use of corporate retention of earnings to minimize double taxation would be wholly unnecessary. The Laissez-Faire Approach counsels repeal of the accumulated earnings tax²⁹⁶ and the personal holding company regime.²⁹⁷

Even if inside shelter is not fully eliminated, the progressive minimization of its significance suggests at least modification of these penalty tax regimes.²⁹⁸ Given that a single shareholder-rate level of tax is normative for the integrationist agenda, the greatest penalty tax that can be justified for the

290. *Id.* § 336.

291. *See id.* § 331.

292. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302 (e)(4)(A), 117 Stat. 752, 763.

293. *Id.* § 303, 117 Stat. at 764. Under a limited reinstatement of the *General Utilities* doctrine, assets could be removed from the corporation without corporate-level taxation only by triggering a full ordinary-rate shareholder-level tax. *See infra* Part X. From the integrationist perspective, that single level of taxation is sufficient.

294. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 303, 117 Stat. 752, 764.

295. *See supra* Part IV, section C.

296. I.R.C. §§ 531-537 (West 2003).

297. *Id.* §§ 541-547. This discussion does not address regimes applicable to earnings retained in a foreign corporation not subject to United States corporate income taxation and subject to relatively low tax rates abroad, for which justifications unrelated to integrationism may exist. *Id.* §§ 551-558 (providing for foreign personal holding company rules); *Id.* §§ 951-964 (providing for controlled foreign corporation rules); *Id.* § 1248 (regarding disposition of stock in certain foreign corporations); *Id.* §§ 1291-1987 (providing for passive foreign investment company rules). *See* Avi-Yonah, *supra* note 16, at 1324-25 (discussing the regime for international corporate taxation).

298. I.R.C. §§ 531, 541 (West 2003).

inappropriate retention of earnings in corporate solution is a tax equal to the benefit of the lower corporate tax brackets as compared to a flat rate corporate tax imposed at the maximum individual income tax rate. As such, even if inside shelter is not fully eliminated, the penalty taxes should be reduced accordingly. In practice, this additional tax revenue may be so slight as not to justify the administrative burden of retaining these regimes.

Further, in the absence of legislative correction of these regimes, the Laissez-Faire Approach counsels leniency in the application of these penalty tax regimes. Courts are urged to interpret these statutory regimes to minimize their applicability. For the IRS, a practice of benign neglect with respect to the policing of these regimes is consistent with the goals of the Laissez-Faire Approach. Here again, this Article remains agnostic as to the authority to act administratively or judicially in this manner.²⁹⁹

X. LIMITED REINSTATEMENT OF THE *GENERAL UTILITIES* DOCTRINE?

For a perspective that makes the double taxation of corporate earnings normative, the *General Utilities* doctrine,³⁰⁰ even in its most innocuous manifestation, was both anomalous and troubling.³⁰¹ In that case, a corporation distributed appreciated assets as a dividend and recognized no gain. The shareholders were taxed on the full value of the asset as dividend distribution³⁰² and, at least in the case of noncorporate taxpayers, took a basis in the assets

299. See *supra* notes 151-52 and accompanying text.

300. See *Gen. Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

301. See, James B. Lewis, *A Proposed New Treatment for Corporate Distribution and Sales in Liquidation*, in 3 HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1643 (Comm. Print 1959) (critizing the *General Utilities* doctrine and offering reform proposals); A.L.I. FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 102-19 (1982) (discussing cost-basis transfers and proposing to revise the *General Utilities* decision by requiring corporations to recognize gain or loss on any corporate distribution of assets to shareholders where basis does not carry over); Clark, *supra* note 16, at 90, 152 (discussing the consequences of the *General Utilities* doctrine and suggesting reform of the doctrine); Bernard Wolfman, *Corporate Distributions of Appreciated Property: The Case of Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81, 87-88 (1985) (favoring repeal of the *General Utilities* Doctrine); George K. Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass It By?* 31 TAX NOTES 1111, 1121 (1986) (rejecting arguments in favor of the *General Utilities* doctrine and concluding that congressional tax reform in 1986 was improved by the repeal of the *General Utilities* decision).

302. *General Utilities*, 296 U.S. at 202-203. The text assumes sufficient earnings and profits to classify the entire distribution as a dividend. See I.R.C. § 301(c) (West 2003).

equal to their fair market value.³⁰³ Although the distribution was fully taxable at the shareholder level as dividend, the fair market value basis granted in the assets ensured that the appreciation would not be subject to a second level of tax.

Given the capital gains tax rate applied to dividends under the 2003 Tax Act,³⁰⁴ the *General Utilities* doctrine could be seen as problematic even from an integrationist perspective. If a corporation recognizes no gain on the distribution of appreciated property, even ordinary income property, and shareholders are taxed at capital gains rates; the reinstatement of *General Utilities* would allow the conversion of ordinary income items into capital gains rate property. From the integrationist perspective, the single-level shareholder tax on corporate items should be taxed according to their characterization at the corporate level, as is the case of the pass-through tax treatment of partners and their partnerships.³⁰⁵ As such, blanket capital gains treatment for dividends without corporate level taxation for distributions of appreciated assets are difficult to justify in combination.

On the other hand, from the integrationist perspective, if the value of the asset is taxable income to shareholders subject to ordinary income tax rates as dividend, no corporate-level tax is indicated. As such, a limited reinstatement of the *General Utilities* doctrine is advisable if the capital gains rate for dividends is allowed to expire³⁰⁶ or if the reinstatement is limited to the distribution of assets that are capital gains assets in the corporation's hands.

If the capital gains rate is allowed to expire, this limited step would require a minor amendment of section 311(b) to provide that a corporate distribution of appreciated property would trigger gain only to the extent that it is not treated as a dividend distribution under section 301; that is, to the extent that the dividend distribution exceeds the corporation's current and accumulated earnings and profits. In the absence of that expiration, the distribution of appreciated property would be limited to corporate capital gains property. This minor step would allow corporations to act themselves to mitigate the excess tax burden of the double tax regime without the need to create additional tax regimes. At the same time, reinstating the *General Utilities* doctrine only to this limited extent would prevent its use, in combination with the capital gains

303. *General Utilities*, 296 U.S. at 202–203. Full market value basis was not available in all cases to corporate distributees. TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988, S. Rep. No. 100-445, at 61, *reprinted in* 1988 U.S.C.C.A.N. 2318, 2320.

304. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 760–64.

305. I.R.C. § 702(b) (West 2003).

306. Jobs and Growth Tax Relief Reconciliation Act of 2003 § 303, 117 Stat. at 764.

preference,³⁰⁷ to create a form of “corporate shelter” in which corporate earnings would be subject to a lower tax burden than noncorporate earnings.³⁰⁸

A. Potential Objections and Responses

A potential objection concerns the distribution of assets subject to debt in excess of their basis. Under existing law, the taxable amount of a dividend distributed in property is the fair market value of the property reduced by the amount of debt to which the property is subject or that the shareholders assume.³⁰⁹ At the same time, the shareholder’s basis in the property is its fair market value.³¹⁰ Therefore, in the absence of corporate-level recognition, an amount of accrued gain equal to the excess of debt over basis would not be taxed at all.

This problem can be avoided by careful drafting of the statutory language to strictly limit *General Utilities* reinstatement to amounts treated as dividends under section 301. The existing statutory definition of the amount distributed reduces the value of the property by the excess of debt over basis.³¹¹ Careful exclusion of that excess from the definition of the “distribution treated as a dividend distribution under section 301” should serve to exclude that excess from the benefit of a limited *General Utilities* reinstatement, which would be the equivalent of reenacting the substance of section 311(c) as it existed immediately before the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986.³¹² Under that provision, a corporation distributing appreciated property recognized gain equal to the excess of debt over basis, but not more than the excess of fair market value over basis if the shareholder did not assume the debt to which the property was subject.³¹³

307. I.R.C. § 1(h) (West 2003).

308. If this limited reinstatement of the *General Utilities* doctrine were pursued, § 355(c) of the Internal Revenue Code would need to be amended to conform with that change.

309. *Id.* § 301(b).

310. *Id.* § 301(d).

311. *Id.* § 301(b)(2)(B).

312. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(c), 100 Stat. 2085, 2272.

313. Former § 311(c) of the Internal Revenue Code provided as follows:

(c) LIABILITY IN EXCESS OF BASIS.—If—

(1) a corporation distributes property to a shareholder with respect to its stock,

(2) such property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and

(3) the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property, then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In

Another potential objection arises with respect to intercorporate distributions of appreciated assets that are eligible for a dividends-received deduction.³¹⁴ The effect of the dividends-received deduction is that the full shareholder-level tax is deferred until the amounts involved are distributed out of corporate solution entirely. At the same time, the recipient corporation takes a fair market value basis in the asset,³¹⁵ enabling it to dispose of the asset without incurring corporate-level tax. This possibility of removing the asset from corporate solution without gain and without triggering shareholder-level tax would convert the limited *General Utilities* reinstatement into a form of inside tax shelter. This problem, however, can be corrected without any major reworking of the code. Limiting the dividends-received deduction to distributions of cash³¹⁶ would be a simple enough matter.

B. Selective Distributions

Another potential objection concerns selective distribution strategies. Corporations will distribute appreciated assets without recognizing corporate-level gain and dispose of loss assets to use the losses against corporate operating profits that would otherwise be subject to dividend taxation at the shareholder level. Allowing this strategy is only problematic, however, if one adopts a double taxation paradigm. From that perspective, loss assets should offset gain assets at the corporate level, which would ensure the double taxation of corporate earnings on distribution.

From an integration perspective this scenario is not problematic. An integrationist perspective calls for each item of profit, gain, or loss to be accounted for just once. In a full pass-through regime, all of these items are

the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

I.R.C. § 311(c). An alternative approach would be to repeal the rule reducing the amount of the distribution by the associated debts assumed or to which the property is taken subject. *Id.* § 311(b)(2). In the context of this program, that repeal would in some cases increase the amount subject to shareholder-level capital gains taxation, *id.* § 301(c)(3), and also increase the amount subject to corporate-level taxation because of being excluded from the limited *General Utilities* reinstatement.

314. See I.R.C. §§ 243-246 (West 2003). Under existing law, not all intercorporate dividends are fully deductible by the recipient corporation. See, however, *supra* Part VI for a proposal to increase the dividends received deduction to 100% of the dividend for all domestic corporations.

315. I.R.C. § 301(d) (West 2003).

316. For these purposes, the distribution of the corporation's own promissory note should be regarded as a distribution of cash. See *supra* notes 238-42 and accompanying text.

netted against each other at the shareholder level. Whether the loss assets offset gain assets or other profits is irrelevant because all items ought to be netted against one another in calculating the amount subject to a single level of tax.

For appreciated assets, the limited reinstatement of the *General Utilities* regime imposes the appropriate single level of tax at the shareholder level. The use of losses accrued on other assets at the corporate level to offset other corporate profits results in no less income subject to taxation than would be the case in a pass-through regime, in which the entity would be entitled to selectively recognize losses for use against operating profits and pass both through to shareholders. The residual flexibility of selective recognition of losses is an artifact of transactionalism's realization-predicated definition of taxable income and not of the integrationist agenda.

C. *Prenegotiated Sales Transactions and Deemed Distributions*

Under the historic *General Utilities* regime, the sale of assets immediately after their distribution created a troubling question of line drawing. If distributed assets were subsequently sold by recipient shareholders in an independent transaction, the subsequent sale did not affect the exemption of the distribution itself from corporate-level tax.³¹⁷ If, however, the sequence of distribution and sale was recharacterized in economic substance to be a disguised sale by the corporation in order to fund the distribution, tax was imposed at both corporate and shareholder levels.³¹⁸ This distinction was thought necessary because the *General Utilities* doctrine was viewed as an exception to the norm of double taxation.³¹⁹

From the integrationist perspective, that distinction is counterproductive and not necessary. The removal of assets from corporate solution, so long as subject to an appropriate shareholder-level tax, ought not to trigger a corporate-level tax even if the asset is immediately sold to a third party. The shareholder-level tax is the sufficient taxation of the asset.

If prenegotiated sales by shareholders are recharacterized as corporate sales, the recharacterization serves only to limit arbitrarily the benefit of this limited *General Utilities* doctrine to circumstances in which shareholders are able to hold the distributed assets usefully themselves or to negotiate independent dispositions of the assets. In practice this limits the efficacy of the restored *General Utilities* doctrine as an integration device, especially in the

317. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 455 (1950) (holding sale by stockholders not taxable as a sale by the distributing corporation).

318. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (treating formal sale by stockholders taxable as actual sale by corporation).

319. *Cumberland Pub. Serv. Co.*, 333 U.S. at 454-55.

case of widely held corporations,³²⁰ whose shareholders would have difficulty organizing a sale of the distributed assets in which they each hold small interests.

Professor Wolfman once objected to viewing the *General Utilities* doctrine as a partial-integration mechanism. He questioned whether:

[The *General Utilities* doctrine] [i]s . . . anything like the partial integration system we would want if we set out to create one? We have opportunities for some corporations some of the time to avoid the corporate tax while others are never able to do so. Can one call that a "system" of partial integration or anything else?³²¹

The answer to his objection is, in the integrationist perspective, not the full elimination of the *General Utilities* doctrine, but the elimination of doctrines that arbitrarily limit its availability as an integration device. Whatever may be said of the substance over form doctrine more generally, its application in this area is inappropriate. As such, its application in cases such as *Court Holding*³²² ought to be set aside.³²³

A potential objection is the wasted transactional costs of inducing corporations to negotiate asset sales to a point just short of consummation, distribute assets, and cause the consummation of the sale in the form of a sale by shareholders. This is indeed a real objection, but there is a simple response. A mechanism ought to be created by which a corporation is deemed to have distributed appreciated assets to shareholders (triggering dividend taxation for the shareholders), and the shareholders are deemed to have returned the assets to the corporation as capital contributions. The deemed distribution would trigger the appropriate single-level shareholder tax. The shareholders' fair

320. This is the most significant case because the availability of pass-through tax treatment for closely held enterprises largely resolves the double-tax problem for those enterprises.

321. Wolfman, *supra* note 301, at 85. *See also* Yin, *supra* note 301, at 1114 ("[I]t is difficult to see how the *General Utilities* doctrine can be seen as effecting a system of partial integration.").

322. *Court Holding Co.*, 324 U.S. at 334 (treating formal sale by stockholders taxable as actual sale by corporation).

323. As in other cases, this Article brackets the question of which actors have the authority to accomplish this result. *See supra* notes 151-52 and accompanying text. Congress could clearly accomplish this result legislatively, and the Supreme Court has the authority to reverse the doctrine when an appropriate case presents itself (bracketing *stare decisis* concerns for purposes of this article). Whether the Service has the authority to set aside the substance over form doctrine for these circumstances is an issue for another day.

market value basis in the assets³²⁴ would ensure no further shareholder taxation on the retransfer with or without the application of nonrecognition for asset transfers by controlling shareholders.³²⁵ The transferred basis of the deemed recontributed asset³²⁶ would ensure no second level of tax at the corporate level. The net result is the appropriate one. The corporation disposes of the appreciated asset triggering a single level of tax at the shareholder level.

The creation of such a mechanism should not create any significant complication for the tax regime.³²⁷ Implementing the mechanism requires no more record keeping, compliance, or administrative burden than does the existing regime, where a distributing corporation is deemed to have sold an asset for its fair market value³²⁸ or where a newly acquired 80% subsidiary elects to be treated as having sold all of its assets for their fair market values.³²⁹ In exchange for creating one more deemed transaction regime, the integration benefits of *General Utilities* would be easily extended to all corporations holding appreciated assets.

D. Liquidating Distributions

Under the existing regime, in a nonsubsidiary liquidation a liquidating corporation generally recognizes corporate level gain or loss with respect to all of its assets,³³⁰ and the corporation's shareholders are treated as having disposed of their shares in a taxable exchange.³³¹ Thus, previously unrecognized gain is subject to both a full corporate-level tax and a capital gains rate tax at the shareholder level. From the integrationist perspective, this is more than the ideal level of tax, which would be the full, individual level of tax.³³²

324. I.R.C. § 301(d) (West 2003).

325. *Id.* § 351.

326. *Id.* § 362(a).

327. Once again, this Article brackets the authority question implicit in this proposal. See *supra* notes 151-52 and accompanying text.

328. I.R.C. § 311(b) (West 2003).

329. *Id.* § 338.

330. *Id.* § 336.

331. *Id.* § 331.

332. In theory, the inside shelter created by corporate tax rates below the maximum individual tax rate could cause the combined tax to be less than the full, individual ordinary-tax rate, but that possibility is remote. In particular, if c is the relevant marginal corporate tax rate, g is the shareholder's capital gains tax rate, and p is the individual's marginal tax rate, then this possibility exists only if $(1-c)(1-g) > (1-p)$, which implies that $c < 1 - [(1-p)/(1-g)]$. If $p = 35\%$, and $g = 20\%$, such inside shelter is available only for $c < 18.75\%$; if $g = 15\%$, inside shelter is available for $c < 23.53\%$. Thus, inside shelter for liquidations is only available for corporations whose marginal corporate tax rate is significantly below the individual ordinary-tax rate. Moreover, a program of

Under the Laissez-Faire Approach, corporations would likely attempt to bypass this result through the formal structuring of liquidating distributions. In anticipation of liquidation, the corporations would distribute appreciated assets as dividends to the extent eligible for corporate nontaxability under the limited *General Utilities* reinstatement. Thereafter, they would distribute the remaining assets as a formal liquidating distribution subject to the existing regime.

From the perspective of the Laissez-Faire Approach, this result is not problematic. The treatment of the formal dividend distribution is the correct treatment. For noncorporate shareholders, the limited reinstatement of *General Utilities* would impose the appropriate single-level shareholder-rate tax. For corporate shareholders, the repeal of the dividends-received deduction for noncash dividends³³³ would also ensure at least a single level of tax.³³⁴ The balance of the liquidating distribution would be subject to gain and loss recognition at both corporate and shareholder levels. The excess tax burden it represents is accepted only because of the Laissez-Faire Approach's limitation to working within the existing regime. As such, the Laissez-Faire Approach counsels that the Service should make no attempt to reclassify the formally distinct dividend distribution as part of the corporate liquidation.

XI. REPEAL SECTION 7704?

The preceding proposals would have the effect of eliminating much, if not most, of the excess burden of the double tax regime. Yet one seemingly obvious and simple step has been reserved until now. Extension of the check-the-box philosophy to publicly traded enterprises by the repeal of mandatory corporate tax treatment of publicly traded partnerships³³⁵ presents perhaps the most obvious element of the Laissez-Faire Approach. The check-the-box regulations allow a noncorporate entity to elect partnership treatment even if it has all four of the corporate characteristics.³³⁶ The limited liability company laws of many jurisdictions allow those enterprises to adopt all of the characteristics traditionally ascribed to corporations.³³⁷ The elimination of this

systematically eliminating the benefit of inside shelter by repealing the lower corporate tax brackets, *see supra* Part IV section C, would eliminate this possibility entirely.

333. *See supra* 314-16 and accompanying text.

334. Full dividend taxation for noncash intercorporate dividend distributions would also imply the adequacy of the existing regime for subsidiary liquidations, in which neither the parent nor the subsidiary recognizes gain or loss and the parent assumes the subsidiary's basis in the assets. I.R.C. §§ 332, 334(b), 337 (West 2003). The proposed regime would create no incentive to bypass the subsidiary liquidation regime in favor of a taxable dividend distribution.

335. *Id.* § 7704.

336. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

337. *See* BISHOP & KLEINBERGER, *supra* note 134, ¶ 1.01[4].

mandatory corporate tax treatment via the repeal of section 7704 would allow full pass-through treatment for businesses that are functionally publicly traded corporations. As section 7704 stands in opposition to the very pass-through model of partnership taxation that is the ultimate integrationist paradigm, the case for its repeal is seemingly obvious.³³⁸ Yet there are serious justifications for maintaining some hesitancy about taking that step, at least in an unadulterated form.

Although the partnership model is the most nearly perfect form of corporate tax integration, that model of integration is consistently rejected on administrability grounds.³³⁹ The Internal Revenue Code's subchapter C,³⁴⁰ which is applicable to taxable corporations, is easier to administer than the Code's subchapter K³⁴¹ and its related audit and adjustment provisions,³⁴² which are applicable to partnerships, especially in the case of widely held enterprises. This is precisely because treating the enterprise as a distinct taxpayer from its shareholders eliminates the problem of tracing enterprise-level tax events to individualized investor tax consequences.³⁴³ On what basis, therefore, would one advocate allowing corporations to elect a regime already dismissed as unadministrable?

Before Congress enacted section 7704, a significant and growing number of enterprises were organized as master limited partnerships—publicly traded

338. Oddly enough, the Treasury first proposed § 7704 in 1984, at the same time that it was proposing partial integration in the form of a 50% dividend-paid deduction. See Hobbs, *supra* note 63, at 504. The logic may have been that, because they were proposing only partial integration for corporations, the fisc needed to prevent do-it-yourself full integration. In 1986 the Treasury urged the adoption of § 7704 because, in the absence of a decision to integrate fully, the Treasury felt obliged to defend the corporate tax base. *Id.* at 505-06. The Treasury indicated that enterprises engaged in equivalent activities ought not to face different tax rates. The Treasury's proposal did not achieve this. To achieve equivalent treatment the Treasury ought to have replaced the corporate tax with a uniform business activities tax or a fully integrated tax. *Id.* at 506.

The Treasury also objected to a proposal to allow do-it-yourself integration to the greatest degree feasible. The Treasury seemed to believe that because the publicly traded partnership structure was not available to existing corporations without a tax cost, it should not be available to anyone. That reasoning would deny pass-through treatment for all new business entities because it would be unavailable to existing C corporations. In any event, the combined effect of the Laissez-Faire Approach should significantly reduce the Treasury's complaint. However, there is the additional question of how the Treasury would have replaced the lost revenue. *Id.* at 507-08. This is a problem of any integration program to which there are potential solutions. It does not seem necessary to go into the solutions in this context because that is not necessary to resolve the problem of organizing an integrationist program, which is what this Article addresses.

339. See *supra* notes 97-99 and accompanying text.

340. I.R.C. §§ 301-385 (West 2003).

341. *Id.* §§ 701-777.

342. *Id.* §§ 6221-6255.

343. Marvin F. Milich, *Master Limited Partnerships*, 20 REAL EST. L.J. 54, 65-66 (1991).

partnerships subject to full partnership tax treatment.³⁴⁴ Even today, there remain master limited partnerships—primarily engaged in real estate or natural resources enterprises³⁴⁵—not subject to corporate tax treatment.³⁴⁶ One might safely presume that managers of these enterprises concluded that the benefit of avoiding the excess burden of the double tax regime is greater than the additional administrative cost incurred by the enterprises that elect partnership over corporate tax treatment. Such an analysis does not serve by itself, however, to justify the free election of partnership treatment by publicly traded enterprises because the private decision makers' calculus of cost and benefit is not complete.

First, it is not clear that the full benefits of pass-through treatment are reflected in an enterprise's decision whether to elect pass-through treatment. Because equity may not bear the full economic incidence of double tax burden, it may not capture the full benefits pass-through treatment generates in terms of allocative efficiency. Even if equity does capture the full benefit of such *de facto* integration, the well-known agency problems of the Berle-Means corporation may prevent its full consideration in the decision whether to elect partnership treatment.³⁴⁷ On the other hand, a failure to elect pass-through treatment may well create no more allocative distortions than exist in the current regime and can be safely ignored.

A second, and more serious concern, is that an enterprise electing partnership treatment is unlikely to bear the full incremental burden imposed by the election of partnership treatment. It seems clear that the administration of the partnership tax rules is more burdensome to fiscal authorities than the administration of the corporate tax rules.³⁴⁸ This administrative concern was one of the Treasury's justifications for the 1987³⁴⁹ adoption of section 7704. Among the cited objections were:

- (1) [T]he allocation of pre-contribution gain or loss to the contributing partner under section 704(c); (2) determining

344. See Hobbs, *supra* note 63, at 502-05.

345. See I.R.C. § 7704(c)-(d) (West 2003). See also Hobbs, *supra* note 63, at 509 ("An MLP is still taxed as a partnership if it derives ninety percent of its gross income from natural resources or real estate." (citing I.R.C. § 7704(c) (1988))).

346. I.R.C. § 7704(c) (West 2003).

347. See *supra* note 35 and accompanying text. A rehearsal of those problems at this juncture, however, would be a needless digression.

348. See William S. McKee, *Master Limited Partnerships*, 260 PRAC. LAW INSTIT. 155, 175-79 (1987).

349. Hobbs, *supra* note 63, at 506-09, 507-08 n.471. "It is interesting to note that . . . the Treasury . . . had [previously] insisted that there were no difficulties in applying subchapter K to large partnerships." *Id.* at 507-08 n.471.

basis adjustments under sections 743(b) and 754; and (3) whether there had been a constructive termination under section 708(b) due to a turnover of fifty percent of partnership interests.³⁵⁰

Other potential issues of administrability that might be considered are the problem of special allocations of partnership items among partners,³⁵¹ the possibility of allocating partnership items through tiers of publicly traded partnerships, and the addition of partnership-level liabilities to partners' bases in their individual partnership interests. Each of these compel the handling of a large number of discrete pieces of data with respect to each individual partnership interest. In addition to the complexity of the tax accounting, auditing is more cumbersome for a publicly traded partnership than for a publicly traded corporation because of the need to trace each audit change to individual investors.³⁵² The enterprise's election to be treated as a partnership imposes additional burdens on the fisc that existing law does not cause the enterprise to internalize. As such, one could expect a more than optimal number of enterprises electing full partnership treatment.

In principle, a simple and elegant solution to this problem is an excise tax. Publicly traded enterprises, and perhaps even nonpublicly traded enterprises with large numbers of equity investors, that elect partnership treatment would be subject to an excise tax that compensates the fisc for the additional administrative burden they impose upon the Treasury. The existing regime imposes a 3.5% annual tax on the gross income of grandfathered publicly traded partnerships,³⁵³ which is imposed as compensation for not reclassifying them as corporations. In principle, that tax could be extended to all publicly traded enterprises that elect partnership treatment.

Whether such a 3.5% excise tax would accurately compensate for the excess cost imposed upon the fisc requires an accurate estimate of that cost. Underestimation would result in too many publicly traded partnerships. Overestimation would serve to reinforce the excess burden of the double tax

350. See *Master Limited Partnerships: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 100th Cong., 1st Sess. 24-25 (1987) [hereinafter *Hearings*] (statement of J. Roger Mentz, Assistant Sec., Dep't of the Treasury).

351. I.R.C. § 704(b) (West 2003).

352. See *McKee*, *supra*, note 348 at 176. The streamlined "TEFRA Partnership Rules," I.R.C. §§ 6221-6234 (West 2003), and the further streamlined rules for "electing large partnerships," *id.* §§ 6240-6255, serve to simplify the problem of tax administration for partnerships with large numbers of members, but these rules do not eliminate the essential problem of tracing audit changes to the individual partners responsible for additional tax, interest, and penalty.

353. I.R.C. § 7704(g) (West 2003).

regime, and a sufficiently high overestimate would have the same practical effect as not repealing section 7704. Nevertheless, in the commonplace absence of accurate empirical data, the 3.5% excise tax is probably a reasonable approximation. On the other hand, the creation of a new tax is contrary to the spirit of the Laissez-Faire Approach. The Laissez-Faire Approach is to do no more than strip away barriers that prevent or dissuade private enterprise from creating a de facto integrated corporate income tax.

In the alternative, one might simply observe that the administrability issue is primarily one of handling large amounts of data. In particular, great amounts of data are necessary with respect to capital accounts and basis calculations made individually for each partnership interest, even though with regard to assets held by the partnership.³⁵⁴ One solution is to hope that technology has resolved, or will shortly resolve, the data handling issue. In the last generation, the cost of computing capacity has shrunk by several orders of magnitude. "In 1980, a gigabyte of storage cost several hundred thousand dollars and occupied a room. It now fits on a credit-card device that can be carried in your pocket."³⁵⁵ It remains an open question as to whether the declining cost of computer technology is sufficient by itself to resolve the data handling component of the administrability concern. The possibility is real enough that it cannot be dismissed out of hand,³⁵⁶ but the creation of software sufficiently economical in its creation and in its operation to justify the application of subchapter K to publicly traded enterprises is beyond the scope of the present analysis.

If advances in data-processing technology are not a sufficient resolution, it may be possible to simplify at least some components of subchapter K, at least as it would apply to publicly traded partnerships, to minimize these concerns. Full resolution of this issue is also beyond the scope of this Article, and it will be addressed in a subsequent Article. It is worth noting here, however, several points that must be borne in mind in creating a simplified version of subchapter K for publicly traded corporations. First, simplifications to subchapter K are likely to reduce its flexibility of application, and therefore,

354. See, e.g., *id.* § 704(c) (requiring special allocations to eliminate disparities between book and tax capital accounts with respect to contributed property whose basis differs from its value as of contribution); *id.* § 743(b) (permitting adjustment to basis of partnership property to reflect gain or loss realized with respect to partnership interests upon a transfer occurring due to the death of a partner, but only in so far as the basis calculation affects that particular partnership interest).

355. PIPPA NORRIS, *DIGITAL DIVIDE: CIVIC ENGAGEMENT, INFORMATION POVERTY, AND THE INTERNET WORLDWIDE* 8 (W. Lance Bennett & Robert M. Ehtman eds., 2001), *quoted in* Peter K. Yu, *Bridging the Digital Divide: Equality in the Information Age*, 20 CARDOZO ARTS & ENT. L.J. 1, 29 (2002).

356. See *Hearings, supra* note 350, at 117-18 (statement of William S. McKee and Mark K. Muller), 149-51 (statement of R. Donald Turlington); Milich, *supra* note 343, at 66.

undermine its desirability. As such, the number of modifications should be kept to a strict minimum, which creates an inherent tension between advancing its administrability for publicly traded enterprises and preserving its flexibility. Second, each distinction in subchapter K as it applies to closely held enterprises compared to publicly traded enterprises places more stress on enforcing the definition of public trading. To that extent, it is not fully consistent with the spirit of the Laissez-Faire Approach, which counsels the reduction of the tax barriers that require costly enforcement. Third, the other components of the Laissez-Faire Approach grant ample opportunities to resolve the problem of the double-tax regime with relative ease. Therefore, a modified subchapter K for publicly traded enterprises is likely to affect fewer enterprises than would be the case were it adopted in isolation, making it both less troubling and less necessary.

XII. MERITS OF THE APPROACH

In considering the policy elements advanced by this Article, it is important to bear in mind that they are intended neither to be a comprehensive catalogue nor a single integrated enactment. It is not so much a comprehensive program as an orientation for policy actions. The Laissez-Faire Approach is just that—an approach. Any policy or practice consistent with its conditions is a candidate for inclusion.

For example, Robert Scarborough has outlined the manner in which corporations are able to use combinations of debt instruments and stock options to reduce the scope of double taxation.³⁵⁷ In a similar vein, Professor Eustice has observed the increase in aggressive corporate tax avoidance (“corporate tax shelters”) in recent years that, “[l]eft unchecked, [may lead to] a significant erosion in the corporate tax base . . . , though not quite attaining, the potential for do-it-yourself integration.”³⁵⁸ To the extent that this is strictly true, such aggressive corporate tax planning mitigates the excess tax burden of the double-tax regime and is unobjectionable to the integrationist norm. The Laissez-Faire Approach counsels acquiescence in any corporate tax planning that has the effect of advancing the integrationist agenda.³⁵⁹ The Laissez-Faire

357. Scarborough, *supra* note 229, at 530-31.

358. James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 139-40 (2002).

359. On the other hand, some such “corporate tax shelters” may go beyond the integrationist goal of eliminating the excess tax burden of double taxation. The integrationist agenda and the Laissez-Faire Approach make no defense of tax planning that allows income to escape the equivalent of a single level individual income tax. Other agendas may make such a defense. For example, a consumption tax agenda might counsel acquiescence in any practice that produces the

Approach can no doubt be advanced by further refinement of the specific proposals of this Article and, more important, by the advancing of other elements that would promote the integrationist agenda.

Likewise, unlike other integration proposals, including the George W. Bush Administration's original proposal,³⁶⁰ the approach presented herein is not intended as a single policy enactment. Rather, the Laissez-Faire Approach is intended to orient the progressive evolution of the tax regime toward the goal of integrationism. The Laissez-Faire Approach can be completed entirely by legislation, but Congress can also acquiesce in a number of positive steps taken by other actors. It can be fulfilled all at once, but it is more likely to approach the integrationist ideal in pieces, slowly, over much time.

The policy analysis advancing a catalogue of appropriate proposals allows for the incremental advance of the integrationist agenda as conditions ripen for individual pieces of legislation, regulatory initiatives, permissive enforcement attitudes, and even judicial action. The extent of legitimate flexibility available to noncongressional actors requires detailed examination that is beyond the scope of this Article. Nevertheless, the example of the check-the-box regulations,³⁶¹ which from the perspective of the Laissez-Faire Approach were a wise regulatory choice, suggests that at least some flexibility is available.

There is widespread belief, premised on substantial evidence, that the double-tax regime is suboptimal in comparison to an integrated tax regime for corporate enterprise. Nevertheless, the problem of administrability prevents a full integration program. Given that the best feasible outcome is partial integration, that a comprehensive partial integration scheme is politically unlikely, and that any practicable tax regime is necessarily an exercise in resolving a second-best problem, the Laissez-Faire Approach fills a significant gap in tax policy discussions. The existing regime is, and will remain, a hybrid of a double-tax regime and an integrated regime, separated by arbitrary boundaries. It is wasteful under these circumstances to expend legal and administrative resources defending the double-tax anti-ideal. The Laissez-Faire Approach accepts this reality and urges the progressive mitigation of the double-tax regime by harnessing the taxpayers' own desire to minimize their tax burden.

indefinite deferral of any taxation at all for economic accruals that remain invested in some business enterprise. The Laissez-Faire Approach, however, is itself fully consistent with aggressive policing for "corporate tax shelters" to the extent that they achieve greater tax reduction than the goal of full corporate tax integration.

360. DEPARTMENT OF THE TREASURY, *supra* note 219, at 11-22.

361. Treas. Reg. §§ 301.7701-2 (as amended in 1999), 301.7701-3 (as amended in 2001).

